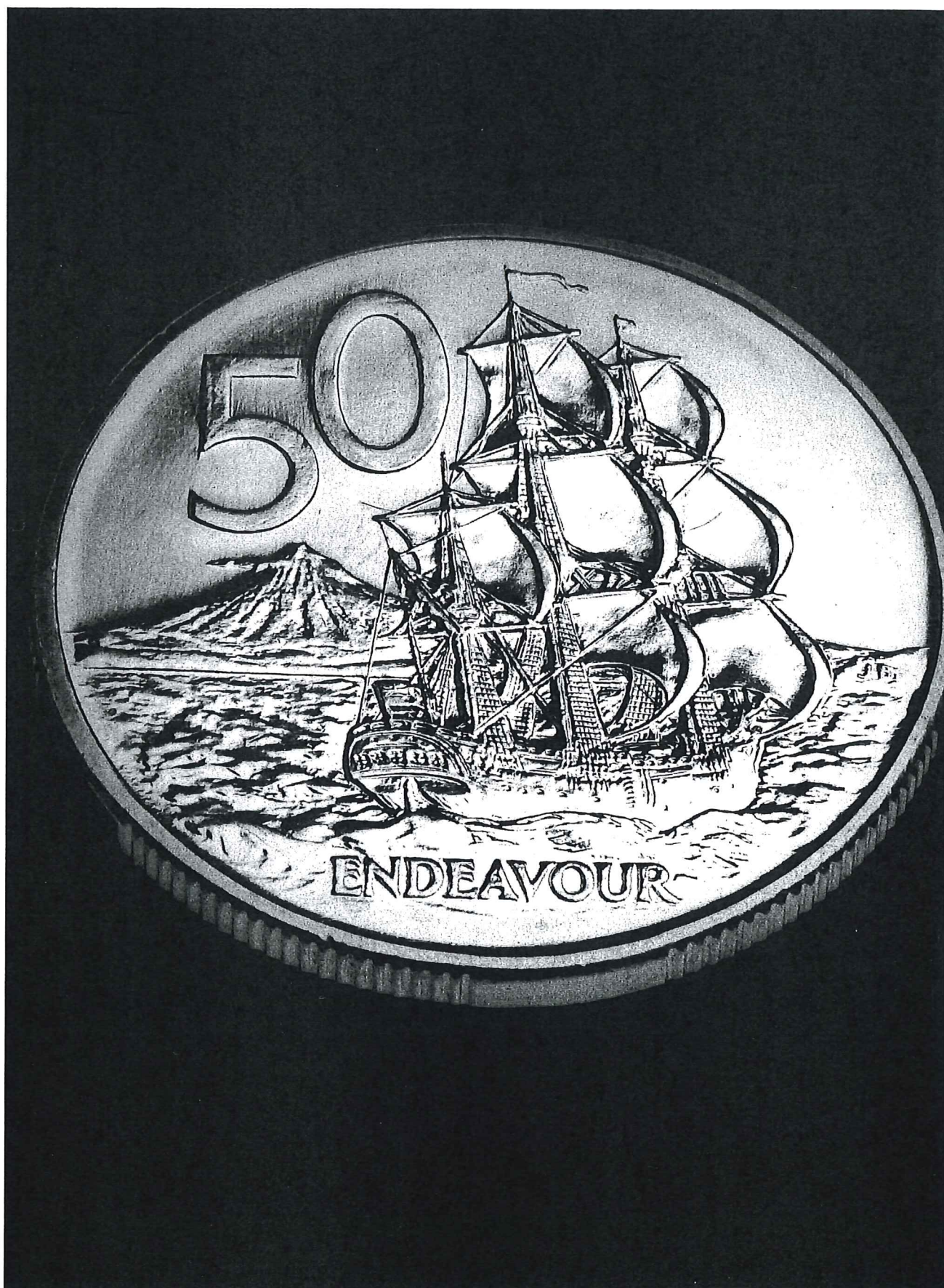




RESERVE
BANK
OF NEW ZEALAND

MONETARY POLICY STATEMENT

June 1996



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(address: <http://www.rbnz.govt.nz>).

Monetary Policy Statement¹

June 1996

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

I. Policy assessment

The short-term inflation outlook presented in this *Statement* is plainly worse than that projected by the Bank even a few months ago. Annual underlying inflation is now expected to peak at about 2.6 percent in the September quarter and is not projected to re-enter the 0 to 2 percent target range until the first half of 1997.

For many observers overseas, this inflation outlook will seem quite moderate. For many in New Zealand, however, the upward revision to our inflation projection will come as an unpleasant surprise. Indeed, against a background of tight monetary conditions and softening demand, many might have expected the Bank to be revising its projections downward at this point and indicating some scope for an easing in monetary conditions.

Fundamentally, the deterioration in the short-term inflation outlook reflects the same factors which have led us to raise our short-term inflation projections progressively for well over a year. Although the growth of spending in the economy has slowed substantially from the unsustainable rates experienced in 1993-94, demand has proved more resilient than expected in the face of firm monetary conditions, while productivity growth has been slower than expected. As a consequence, strains on the productive capacity of the economy, and the resulting upward pressures on inflation, particularly in the property sector, have been slower to dissipate than expected.

In assessing the appropriate stance of policy at this juncture, a number of factors must be borne in mind. The first is that any adjustment in the stance of monetary policy now would have only a marginal impact on inflation over the next six months. So, however disagreeable the immediate inflation prospect, monetary policy actions need to be geared to influencing inflation outcomes in the period beyond the end of 1996.

Second, inflation outcomes in the first half of 1997 are within the scope of monetary policy influence, essentially through the direct influence of exchange rate and interest rate movements on traded goods prices and asset prices represented in the Consumers' Price Index. At this stage, and on the basis of the monetary conditions assumed in our projections, the annual rate of inflation through the first half of 1997 seems likely to be declining rapidly, while annualized quarterly rates of inflation will be close to the middle of the target range.

Third, in the second half of 1997 and beyond the outlook is for further declines in inflation, on both the annual and quarterly measures. This suggests that, if the outlook

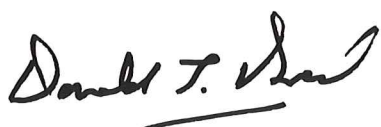
¹ Text finalised on 18 June, based on data available to 17 June. Inflation projection based on data available to 14 June.

for underlying inflation evolves essentially along the lines projected, some easing of monetary conditions will become appropriate in due course.

That time has not yet arrived. There is still too much uncertainty about whether we are witnessing a genuine turn-around of inflationary pressures, in the housing market in particular; too much very recent, and very strong, growth in credit demand; too much evidence more generally of strong demand pressures; and too much uncertainty about how the economy will react to the imminent fiscal stimulus for any easing to be considered at this stage. The favourable medium-term forecasts are themselves conditional on monetary conditions remaining, in aggregate, as firm as we have assumed in this *Statement* - that is, broadly in line with the recent mix of conditions, 90-day bank bill rates of around 10 percent and an average value for the trade-weighted exchange rate index of 64.0 for the September quarter, appreciating thereafter at 1.7 percent per annum.

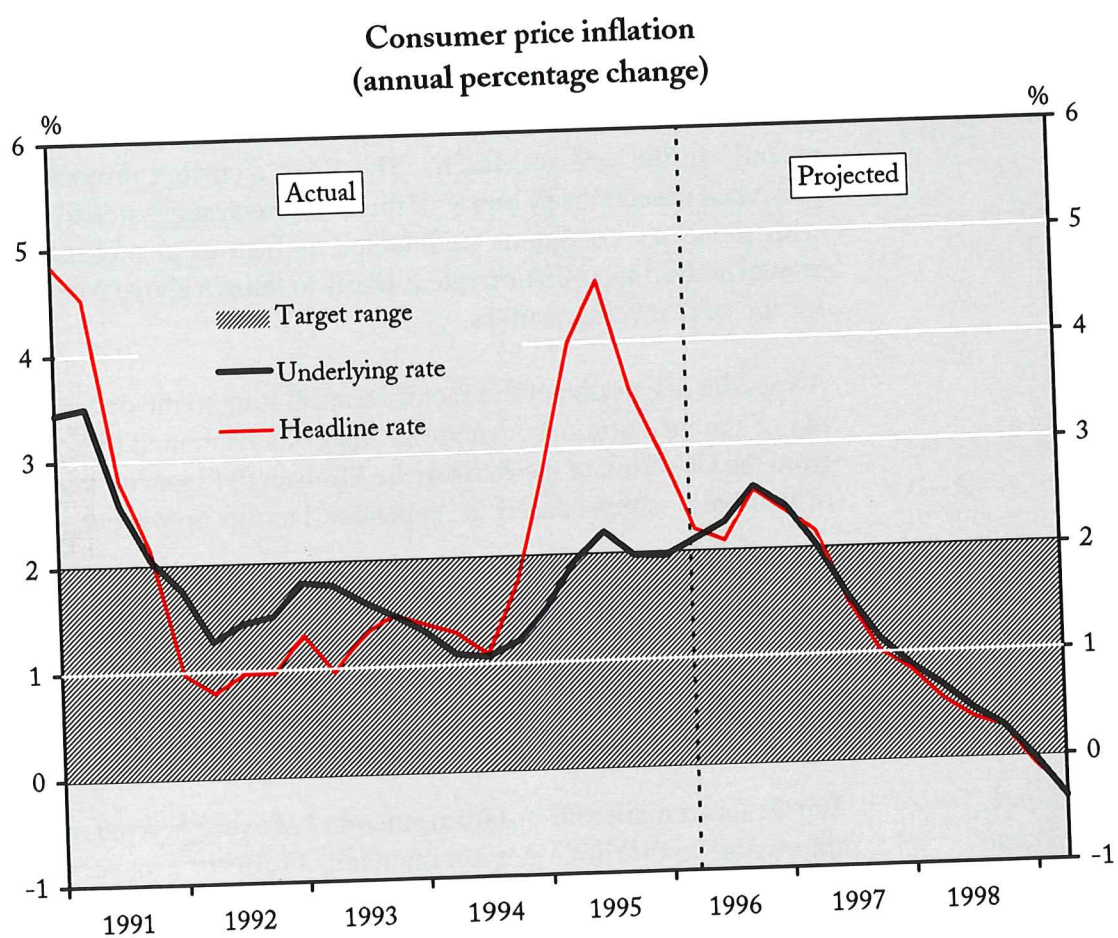
As always, we will be monitoring the emerging data closely for signs either that a tighter stance is required or that there is some more obvious scope for us to accommodate an easing in conditions. Although we expect that many observers will be taken by surprise by the extent of the deterioration in the short-term inflation outlook, we are not seeking any firming in conditions relative to those assumed here. By the same token, however, we will guard against - and resist vigorously if necessary - any significant easing in conditions relative to those assumed in this *Statement* in the absence of conclusive evidence that inflation will drop away sharply next year and beyond.

The Bank cannot, of course, control the mix of conditions. Some rebalancing of conditions - for example, in favour of relatively more interest rate pressure and a slightly lower exchange rate - is always possible. What matters primarily to us is that overall conditions - a mix of, *inter alia*, retail and wholesale interest rates and the exchange rate - remain appropriately firm.

A handwritten signature in black ink, appearing to read 'Donald T. Brash', with a horizontal line underneath the name.

Donald T Brash
Governor

Figure 1



II. Issues facing monetary policy

Further breaches of the 0 to 2 percent target are likely.

Over the past year or so, the annual underlying rate of consumer price inflation in New Zealand has hovered around 2 percent. On two occasions, inflation has slightly exceeded the Bank's 0 to 2 percent target range; once in the year to June 1995, and most recently in the year to March. The Bank's current projections, presented in sections IV and V of this *Statement*, suggest that, even with monetary conditions maintained as firm as at present, the annual underlying inflation rate is likely to remain above 2 percent for the next several quarters.

A specific discussion of the factors contributing to the overshooting of the inflation target range in March is contained in a letter from the Governor of the Bank to the Minister of Finance. The text of that letter is reproduced in Appendix 2 to this *Statement*.

From an historical, or from an offshore observer's, perspective, achieving a peak inflation rate of between 2 and 3 percent, after several years of economic expansion and falling unemployment, could be regarded as a remarkable success, and a strong endorsement of New Zealand's monetary policy framework.

Past and projected breaches raise the question ...

But the fact remains that inflation outcomes of over 2 percent, while impossible to rule out, were not intended. From our own perspective, therefore, underlying inflation outcomes outside the target range are a disappointment and lead us to reflect not only on what more should be done to ensure that inflation returns to the target range, but also on how best to ensure that inflation outcomes outside the target range are limited as much as possible with respect to frequency, extent and duration.

... what have we learnt from recent experience?

The focus of this section is on the lessons we believe we can draw from our experience during the current economic cycle and their relevance to the conduct of monetary policy in the future.

(i) Aims and outcomes

The Policy Targets Agreement ...

The *Policy Targets Agreement* (PTA) between the Minister of Finance and the Governor of the Bank sets out a clear objective for monetary policy: annual increases in the Consumers' Price Index (CPI) of 0 to 2 percent. The PTA also requires the Bank to explain inflation outcomes outside the 0 to 2 percent range.

... sets a clear objective for monetary policy ...

In some cases, excursions from the target range will reflect the effects of particular kinds of price disturbances covered by 'caveats' in the PTA. For example, in late 1994, higher interest rates were largely responsible for the rise in the official, or 'headline',

rate of inflation to above 2 percent.¹ Since the direct effects of interest rate movements on the CPI inflation rate are covered by the 'caveats', this breach of the target range was not regarded as reflecting inadequate monetary policy.

... and requires that the Bank explain ...

The Bank's measure of underlying inflation seeks to distinguish between movements in the inflation rate resulting from disturbances covered by the 'caveats' and those which are not. The underlying inflation measure represents, in effect, the inflation rate for which monetary policy is most fully responsible in terms of accountability.

... outcomes beyond the target range.

Whether one focuses on the headline inflation rate, or on the underlying rate, both are measures of inflation *outcomes*. Even a very clear specification of the desired outcome, however, does not guarantee its achievement. The Bank's task, and its responsibility, is to do all that it can to achieve the desired outcome.

The Bank bases policy on inflation prospects ...

In formulating monetary policy, however, the Bank needs to respond to inflation prospects rather than inflation outcomes. This reflects the fact that monetary policy works by influencing the expectations and decisions of individuals throughout the economy, and that it takes time for these to affect activity and the prices represented in the CPI.

... which are inevitably uncertain.

How closely the Bank's aim of keeping inflation within the 0 to 2 percent range translates into inflation outcomes within that range depends on a number of considerations. One of the most important is how well the Bank is able to anticipate the effects on future inflation of past developments and policy adjustments in the economy. Furthermore, any economic projection must make assumptions about future developments and policy adjustments, both at home and abroad. To the extent that these assumptions are not borne out in reality, the projection, and policy adjustments based on the projection, will be in error.

Inflation outcomes cannot be precisely controlled ...

These considerations mean that the setting of monetary policy is unavoidably subject to uncertainty, and that inflation outcomes cannot be controlled precisely. Moreover, the longer the time that it takes for policy to influence inflation, and the less accurate is our knowledge of the way in which the economy works, the less precise will be our control over inflation outcomes.

1

Current mortgage interest rates and other credit charges have a significant weighting in the New Zealand CPI, in common with the UK RPI and the Australian CPI, and in contrast with the CPIs of most other countries including, notably, the US, Japan, and Germany. A consequence of this is that, in New Zealand, a monetary policy-induced firming of interest rates has an initially perverse effect of raising the measured 'headline' inflation rate. For this reason, the Bank focuses more closely on the CPI excluding credit charges.

... resulting in the risk of breaches of the inflation target range.

The inherent imprecision associated with monetary policy influence over inflation outcomes has two particularly important implications. The first is that, no matter how monetary policy is operated, there will always be a risk of inflation outcomes outside the 0 to 2 percent target range. Monetary policy can *aim* to keep inflation within a 0 to 2 percent range, but cannot guarantee it.

Aiming at the middle of the target range ...

A second implication of imprecise control over inflation outcomes is that if the Bank aimed for an inflation outcome close to the edge of the target range, it would run a higher risk of an unintended breach than if it aimed at outcomes well within the range. Since the Bank is as keen to avoid undershooting of the target range as overshooting of the range, it follows that by aiming for inflation outcomes in the central part of the target range we stand the best chance of achieving outcomes within the 0 to 2 percent range.

... minimises the risks of inflation outside 0 to 2 percent.

The importance of aiming to produce inflation outcomes in the central part of the target range is underscored by our experience with inflation over the past couple of years. In retrospect, we were too tolerant of the prospect of inflation outcomes well above the centre of the range. This simply left too little room on the upside for accommodating forecasting uncertainties and still have outcomes inside the range, and contributed towards delay in responding to accumulating upward pressures on inflation.

(ii) The policy horizon

Recent experience has been instructive.

In the discussion above, the importance of basing monetary policy actions on inflation prospects has been emphasised, but no reference has been made to whether policy should be responding to the inflation outlook in the immediate future, or whether the focus should be on inflation prospects further out. The experience of the past couple of years has been instructive in this regard as well.

Rises in inflation ...

The rise in inflation in New Zealand over the past two years cannot be attributed to higher prices for internationally traded goods and services represented in the CPI. Indeed, the 'imported' component of inflation has been helping to hold down the overall inflation rate, not raise it.

... have reflected domestic pressures.

Rising inflation has instead stemmed from domestic price pressures. While it is easy to point to specific developments contributing to higher inflation, even on the underlying measure, the more general upward trend of inflation reflects the fact that the expansion of demand during the cyclical upswing since 1992 outstripped the sustainable, non-inflationary productive capacity of the economy. As is discussed in greater detail in Sections IV and V of this *Statement*, strains on capacity and prices have been most prominent in the housing sector, but are by no means confined to that sector.

The Bank was too optimistic about the non-inflationary capacity of the economy ...

The restructuring and opening up of the New Zealand economy over the past decade make it difficult to judge just how rapidly the non-inflationary capacity of the economy is able to expand. But it is evident that, in developing our inflation projections over the past few years, the Bank - like most other forecasters - took too optimistic a view of how far and how fast demand could expand before putting significant upward pressures on prices.

... and responded insufficiently forcefully to emerging excess demand.

It is also probably fair to say that the moderate performance of wage behaviour in recent years lulled most forecasters - including the Bank - into adopting too rosy a view of the extent to which excess demand pressures would feed into inflation. For both of these reasons, and despite the Bank's shift towards a more restrictive policy stance early in 1994, our actions to dampen the pressures that gave rise to increased inflation must be regarded in retrospect as insufficiently forceful.

Policy aimed at medium-term control of inflation ...

This experience underscores the judgment that if monetary policy is to maintain good medium-term control over inflation, it needs to respond at an early stage to signs of demand significantly outstripping, or falling short of, the economy's sustainable capacity. In other words, monetary policy needs to look well ahead, to the pressures that generate inflation, not just at inflation itself. If policy adjustments are delayed until rising (or falling) inflation is readily evident, the task of restoring price stability becomes much more difficult.

... will also affect inflation in the short term ...

A particular challenge for monetary policy in New Zealand, reflecting the openness of the economy and the fact that we have virtually no influence over world prices, is that even if our monetary policy actions were focused squarely on the medium-term inflation outlook, our policy actions will also affect inflation in the shorter term. This is because movements in the exchange rate will have a relatively significant direct impact on the domestic prices of internationally traded goods and services. In addition, the New Zealand CPI differs from its counterparts in many countries by including some property prices. A consequence is that movements in interest rates will tend to have a direct impact on the CPI, through their effect on the prices of property assets represented in the CPI. These direct effects of policy adjustment will typically affect inflation temporarily, but relatively rapidly.

... - although not always in a helpful manner - ...

In some circumstances, monetary policy adjustments aimed at maintaining medium-term price stability will generate shorter-term inflation effects that push inflation away from the centre of the target range. In other circumstances, policy adjustments appropriate to maintaining short-term price stability will also be appropriate from a medium-term perspective.

*... as illustrated
by our experi-
ence in early
1994.*

In early 1994, for example, the Bank's projections suggested that, on the basis of unchanged monetary conditions, inflation was likely to dip to as low as 0.6 percent in the year to March 1995, but then rise to over 1.5 percent in 1996. Had the Bank's policy horizon focused solely on the period beyond about 18 months, the appropriate course of action would have been to tighten conditions immediately. In the short run, however, such a course of action would have tended to push inflation in mid-1995 even closer to the bottom of the 0 to 2 percent target range.

Conversely, had the Bank focused solely on the short-term inflation outlook, the appropriate action might have been to loosen conditions, to bring 1995 inflation closer to the centre of the range. Such action, however, would have aggravated the inflation pressures further out.

*The Bank has to
balance the risks
to the target
range at different
horizons.*

At the time, the Bank indicated that no adjustment of monetary conditions appeared necessary. In retrospect, the Bank ought to have paid much more attention to the medium-term projection of a deterioration in inflation performance. The more general point illustrated by this experience is that, in some situations, the Bank will have to strike a balance between reducing the risk of breaching the edges of the target range in the short term versus reducing the risk of breaches in the medium term.

In other situations, life is more straight-forward, and there is no significant conflict between objectives. Since the latter part of 1994, for example, both the near-term and medium-term outlook has generally been for inflation in the upper half of the target range. In this case, policy adjustments aimed at producing inflation outcomes closer to the middle of the range in the shorter term also work to bring medium-term inflation outcomes closer to the centre of the range.

*Recent experi-
ence suggests:
monetary
policy ...*

The above discussion has a number of important implications for the Bank's approach to policy, both at the general level, and in the current situation. The first is that although the risks of inflation outcomes outside the 0 to 2 percent target range can be reduced by aiming at the centre of the range, the task for monetary policy in New Zealand is complicated by the fact that changes in the stance of monetary policy can have a significant, if temporary, impact on measured inflation in the short term in addition to the longer-term effects of policy.

*... directed at one
horizon may be
at odds with
another; ..*

Actions aimed at bringing inflation close to the centre of the target range at one horizon may be at odds with stabilising prices at another horizon. As a result, assessment of the appropriate stance of policy will need, at times, to balance the risks of breaching the target range in the short term against risks of breaching the target range in the medium term.

*... medium-term
inflation consid-
erations ...*

The Bank's experience over the past few years also suggests that medium-term inflation considerations need to be accorded a somewhat greater weight in determining the appropriate stance of policy. Had the Bank focused to a greater extent on the medium-term inflation outlook, we would have responded earlier, or more forcefully, to the emergence of inflation pressures. That is not to say, however, that a more medium-term emphasis in policy formulation could have guaranteed appropriate policy adjustments.

*... should be
accorded more
weight.*

If inflation projections are in error, so too will be policy adjustments based upon them. The fact that the Bank has tended to underestimate the extent of inflation pressures in recent years (an issue discussed in our December 1995 *Statement*) means that, even if the Bank had based its policy adjustments to a much greater extent on its medium-term inflation projections, inflation might still have risen above 2 percent.

But it can also be said that had the Bank ignored the medium-term outlook altogether, the shift in the stance of policy towards restraint would have been delayed and the eventual breach of the target range even more serious.

*At times, the
inflation outlook
at different
horizons can
differ markedly.*

A related conclusion is that it is likely that, as upward pressures on inflation give way to downward pressures, the short-run inflation outlook will be quite substantially different from the medium-term outlook. In some important respects, we will be in nearly the reverse of the situation of late-1993 - early-1994. At that point, the short-term prospects for inflation will continue to point to the need for additional policy tightening, or, at minimum, maintaining a firm stance. Simultaneously, however, it could well be that aiming to keep medium-term inflation prospects near the centre of the target range would require an easing of the stance of policy. Judging how close we are to that awkward position is the substance of this *Statement*.

III. Financial market developments

(i) Policy signalling

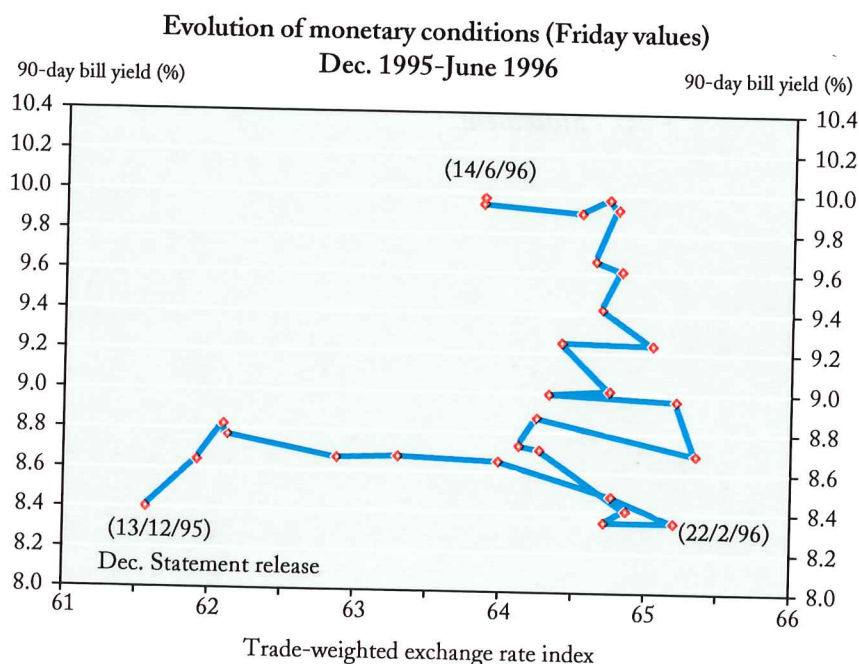
Monetary conditions have tightened since December 1995, with both ...

... the level and the mix of conditions adjusting appropriately.

Apart from the regular statements accompanying the December 1995 *Monetary Policy Statement* and the March 1996 *Economic Projections*, the Bank has not made any official comments intended to affect monetary conditions since early November. The relative absence of comments and signals from the Bank - compared with 1995 in particular - has been primarily because monetary conditions have stayed within an acceptable range. That, in turn, appears to have been because the market's assessment of the appropriate degree of monetary pressure has been similar to our own. As a result, conditions have progressively tightened more or less in line with the emerging data suggesting that inflation pressures were proving unexpectedly persistent.

Although conditions have tightened fairly steadily, the form of the tightening has changed considerably. Since February, a sharp reversal in expectations about the future direction of monetary policy in other countries has transferred the upward pressure from the exchange rate to higher domestic interest rates. As a result, the mix of overall conditions changed to be more in line with our own assessment of the major sources of inflationary pressure. Recent months illustrate again that the Bank can control the level of overall conditions, but that the market dictates the mix of conditions.

Figure 2



(ii) Changing views of the stance of policy

Expectations have played a major role in recent developments.

Many of the developments in the New Zealand market over the last six months are best understood primarily as responses to changing expectations about the future stance of monetary policy - both our's and those of other countries. In the lead-up to the December *Monetary Policy Statement*, the market expected conditions to remain firm in early 1996 and then to ease somewhat near the middle of the year. By June 1996, for example, 90-day yields were expected to have fallen to around 7.75 percent. As a result, the market was surprised by the more pessimistic view on inflation taken in the *Statement*, and the implication that firmer monetary conditions would be needed for an extended period ahead.

Initially, the exchange rate rose, as markets expected firmer conditions at home than abroad, ...

At around the same time, the policy stance in other countries was increasingly expected to become easier - particularly in the US where official interest rates were cut in both December and January, more aggressively than expected. The sharp and sudden divergence in the expected paths of interest rates here and abroad provided a powerful boost to the value of the New Zealand dollar. Though short-term interest rates rose initially, the bulk of the firming in conditions over the two months following the *Statement* occurred through a rise in the exchange rate. Over this period, the New Zealand dollar appreciated by around five percent to around 65 on the Bank's trade-weighted index (TWI).

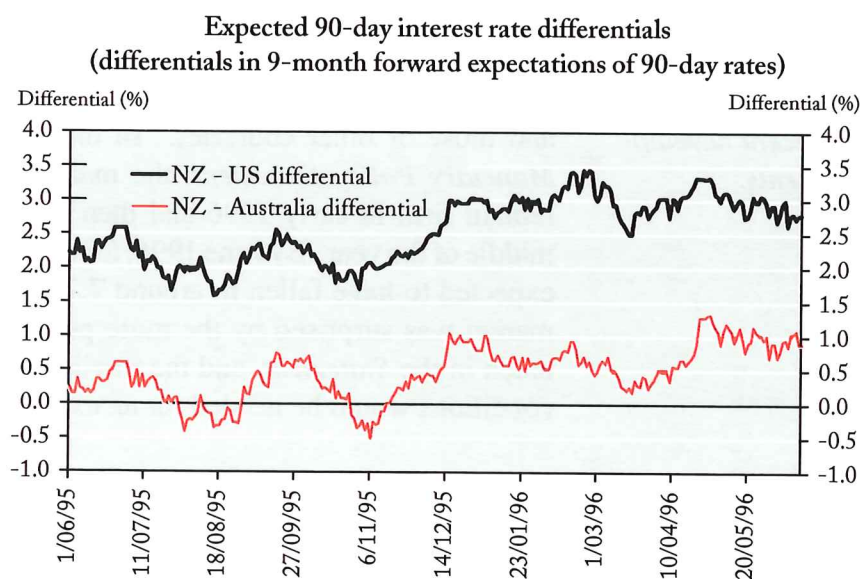
... but since mid-February short-term interest rates have increased ...

In mid-February, however, economic indicators in the US and comments by the US Federal Reserve Board chairman prompted investors to revise sharply upwards their expectations about future US monetary policy and, hence, short-term interest rates. In mid-February, before the reversal in sentiment began, the market expected that official US interest rates would have been *cut* by a further 50 basis points by December 1996. By contrast, at the time of writing the same market expects that by December 1996 US rates will have been *raised* by around 100 basis points. The changed outlook placed upward pressure on long-term interest rates - not, it appears, because inflation expectations were higher, but because short-term interest rates were expected to be higher for longer.

... in response to ongoing indications of inflationary pressures.

There has not been the same sort of reversal in views about the direction of policy in New Zealand. However, the market has become steadily more pessimistic about inflation prospects, reinforced by the Bank's March *Economic Projections* and subsequent unfavourable indicators. As the outlook for inflation worsened, monetary conditions generally continued to firm but the form of the tightening changed. Until February the tightening was reflected in a higher TWI, because conditions here were seen as tightening relative to those abroad. Since February, however, it has been interest rates which have moved up (90-day yields have risen steadily to around 10 percent). The tighter stance expected to prevail here over the next couple of years has broadly been matched

Figure 3



Note: The NZ - US differential on 1 June 1995, for example, shows the expectation on that date of what the 90-day interest differential would be on 1 March 1996.

by an increase in expected foreign interest rates. Coupled with increasing market concerns about the risk of a future fall in the exchange rate - whether associated with an eventual monetary policy easing or a sense of real exchange rate overvaluation - the TWI settled in a 64.0-65.3 range from early February until early June.

(iii) Trends in the bond market

Bond yields climbed, partially on the back of higher foreign rates, ...

New Zealand 10-year bond yields have risen dramatically in recent months, up by around 190 basis points from the 18 month low of 6.9 percent in early February. The higher foreign rates alluded to earlier have contributed to the rise - US bond yields have risen about 140 basis points for example - but New Zealand 10-year bond rates have risen by much more than those in the US and Australia.

... but largely due to firmer domestic conditions, ...

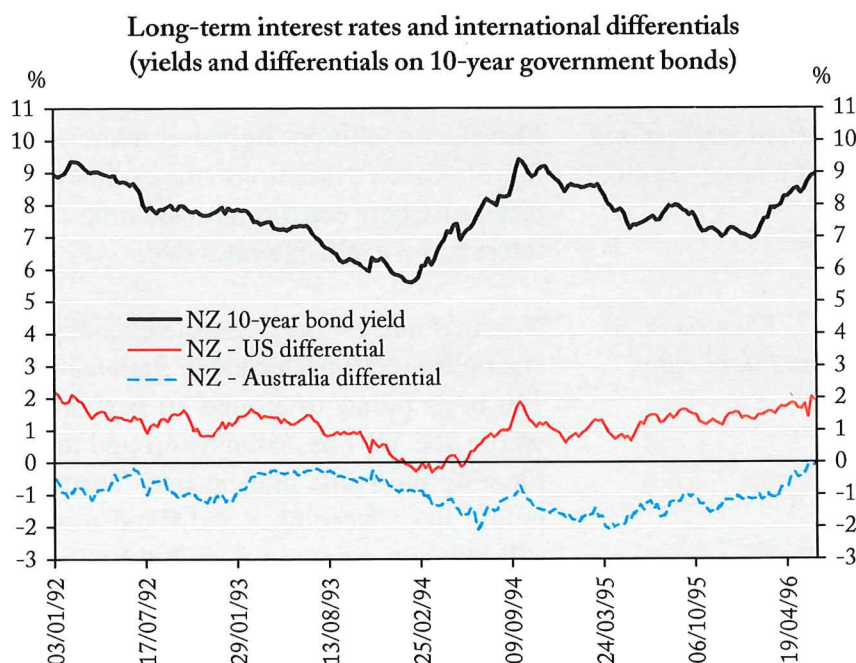
A major factor behind this has been that, over the period as a whole, both current and expected domestic monetary conditions have firmed relative to offshore. Actual funding costs have risen sharply here, whereas they have been flat or lower in other countries. Interest rates are also expected to be higher for longer in New Zealand, relative to other countries, than was the case last year. Accordingly, our long-term rates have risen by more than those offshore.

... although, recently, political risk has also been a factor.

However, in the last couple of months there has been no further tightening in the market's expectations of the stance of policy here relative to that in the US, for example. Despite this, our bond market has continued to under-perform. The other frequently-cited influence has been politics. For most of the period, uncertainty associated with the upcoming election appeared to explain a relatively small proportion of the overall rise in interest rates - transitory effects apart. But in the last month or so, election uncertainties appear to have become a more prominent consideration in both the money and foreign exchange markets. The recent widening in the 10-year differential along with the fall in the currency to around 64 on the TWI in recent weeks are both consistent with some increase in the political risk premium.

Another indication of the increased prominence of political risk may be the widening in the spread between conventional and indexed bond yields since mid-May¹. Since the last inflation indexed bond tender on 16 May, nominal bond yields have risen by around 60 basis points but indexed yields have not changed. Previously these two rates had moved pretty much in step - albeit in a relatively thin and illiquid market. The recent divergence between real and nominal yields may reflect increased uncertainty about the future of the macroeconomic policy framework. Such

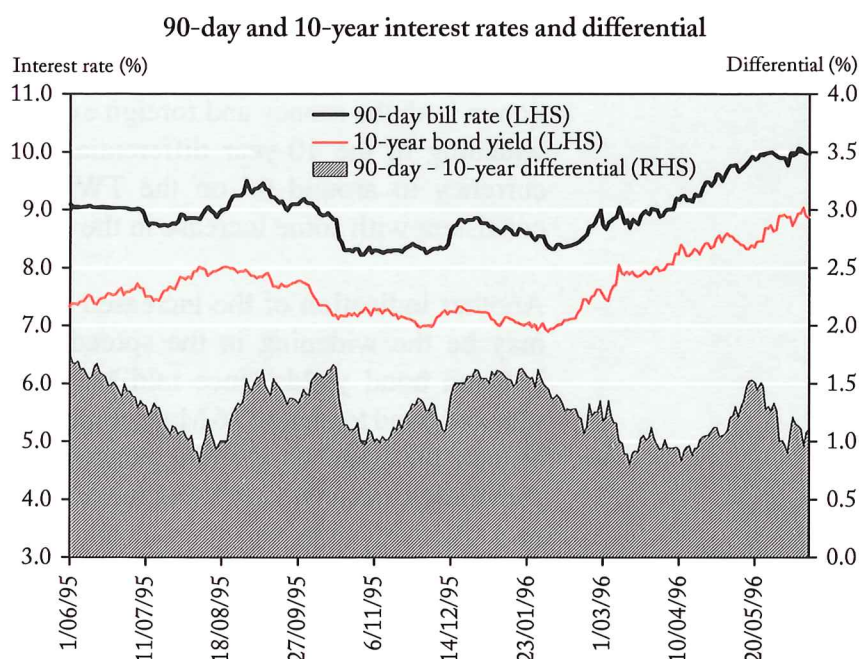
Figure 4



¹ Inflation-indexed bonds offer investors protection against inflation by offering a yield indexed to the Consumers' Price Index. The secondary market yield on index-linked bonds is hence a direct measure of the long-term real interest rate. The difference between this and the rate on ordinary long-term bonds is a proxy for a combination of long-term expected inflation and uncertainty about the outlook for inflation.

uncertainty increases the value of the insurance, against changes from the status quo, that indexed bonds provide. What is less clear is the extent to which the long-term average inflation rate expected by bond investors may have changed.

Figure 5



(iv) Assessment of conditions

Real interest and exchange rates ...

Monetary conditions tighten if interest rates rise by more than the rate of expected inflation or the exchange rate rises by more than the difference between foreign and domestic inflation rates, ie, if 'real' interest and exchange rates rise.

... have risen, as nominal rates ...

Nominal interest rates and the exchange rate have increased substantially since the *December Statement* - 90-day yields have risen 160 basis points to around 10 percent and, over the period as a whole, the TWI has risen by around three percent to just over 64. Floating mortgage interest rates have risen by around 100 basis points since December and fixed mortgage rates have risen by substantially more (up over 200 basis points for one year terms). The move in fixed rates is particularly significant as much of the new lending by institutions in the last year or so has been on fixed rates - these rates had been particularly low relative to floating rates.

... increased by more than inflation expectations ...

Have inflation expectations risen sufficiently to offset the rise in nominal interest rates, leaving underlying real interest rates unchanged? As noted above, the longer-term inflation concerns of the financial sector may have risen recently with political events.

However, survey data generally do not suggest that household or business inflation expectations have changed significantly in recent months (see Section V), although none of these surveys has been updated since the latest apparent rise in nervousness about the longer-term outlook.

*... leading to
considerably
tighter
conditions.*

With little evidence of much change in short-term inflation expectations here (or abroad), the magnitude of the rise in nominal short-term interest rates leaves little doubt that real rates have risen considerably. Longer-term real rates also appear to have risen considerably, although by less than the extent of the rise in nominal yields. The rise in the TWI has also been more than the difference between New Zealand and world inflation over the period. Accordingly, over the period as a whole, conditions have tightened considerably.

IV. Economic activity: recent developments and outlook

Excess demand is a key influence on inflation.

The Bank considers a range of factors when forming its assessment of the outlook for inflation. A key factor is the projection of economic activity. When compared with an appraisal of the economy's sustainable productive capacity, this provides an indication of the extent to which strains on the economy's productive capacity are likely to put upward or downward pressure on inflation.

Stronger activity in the near term ...

Information gathered since the Bank finalised the March 1996 *Economic Projections* indicates that economic activity has been stronger than expected. Consequently, the extent of excess demand has not declined by as much as the Bank had anticipated. This is reflected in the higher near-term projections for inflation discussed in Section V.

... will be reversed over the longer term when growth is expected to weaken.

However, looking beyond the short term, *on the basis of the technical assumptions discussed below*, the Bank has revised down its projections of economic growth. Firm monetary conditions and increasing economic uncertainty (reflected in recent developments in the housing market) are expected to dampen business and consumer confidence, and spending, to a greater extent than projected in March. These factors are only partially offset by a slightly improved outlook for world economic growth. Although in the near term the balance of risks points to the possibility of slightly stronger growth, over the medium term the uncertainties surrounding this projection are judged to be broadly in balance.

(i) Recent trends and developments¹

Economic activity has been stronger than expected ...

Aggregate demand has been more resilient than seemed likely when we developed the March *Economic Projections*. We now estimate that the level of economic activity grew by around 2.2 percent between the March quarters of 1995 and 1996 - around 0.7 percent stronger than we had previously estimated. The upward revision to our estimate of growth reflects both published GDP statistics for the December 1995 quarter, and economic indicators relating to the March 1996 quarter.

¹ The GDP statistics, estimates, and projections referred to in this section are based on Statistics New Zealand's official production-based constant price (real) GDP series. At present, this series is calculated based on prices prevailing in the economy in 1982/83. Revised series, calculated based on prices prevailing in the economy in 1991/92, are scheduled to be published by Statistics New Zealand on 28 June 1996.

... both in the December quarter ...

Real GDP grew by 0.6 percent in the December quarter, taking the annual (point-to-point) rate of growth to 2.4 percent over the year to December 1995 (measured using the production-based approach). Growth during the December quarter was much stronger than we had expected. The largest source of error was in our estimate of manufacturing sector output. In aggregate, this proved more robust than had been suggested by export volume data.

and in the March quarter:

Key economic indicators of both aggregate demand and production generally point to a further increase in aggregate activity of around 0.7 percent in the March 1996 quarter.

retail sales strengthened;

- The volume of retail sales increased by 3 percent during the March quarter. When combined with other indicators of consumer spending, this suggests that household consumption grew by slightly less than 2 percent during the quarter. Strong growth in consumption is also reflected in import volumes.

the housing market has been buoyant;

- Activity in the housing market also continued to grow rapidly, characterised by a record high level of house sales, a further surge in building consents, and the strongest growth in house prices recorded since Valuation New Zealand's quarterly series began in 1989.²

non-commodity export growth has recovered;

- Growth in exports of non-commodity manufactures appears to have recovered during the March quarter following a fall in the December quarter.

broad money and credit growth remains strong ...

- While growth in M1 has remained relatively weak in recent months, annual growth in the broader money and credit aggregates (M3R and PSCR) and credit card advances has continued to increase at double-digit rates.

... as does employment growth.

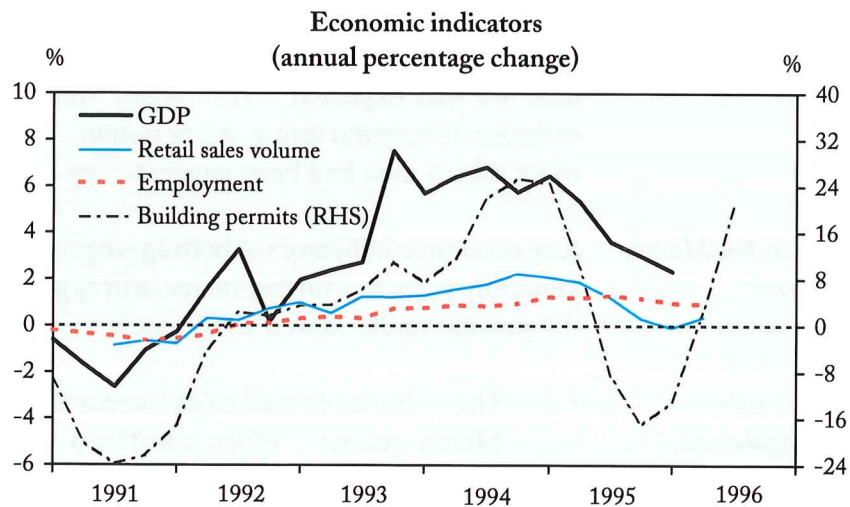
- The Household Labour Force Survey recorded employment growth of 0.8 percent during the March quarter, with even stronger growth recorded in the number of hours worked. Growth in the number of job advertisements has slowed, but the level remains very high.

But capacity utilisation has fallen.

- In contrast, the New Zealand Institute of Economic Research's measure of capacity utilisation recorded the first major decline in the current economic cycle. This decline was solely attributable to developments in the manufacturing sector.

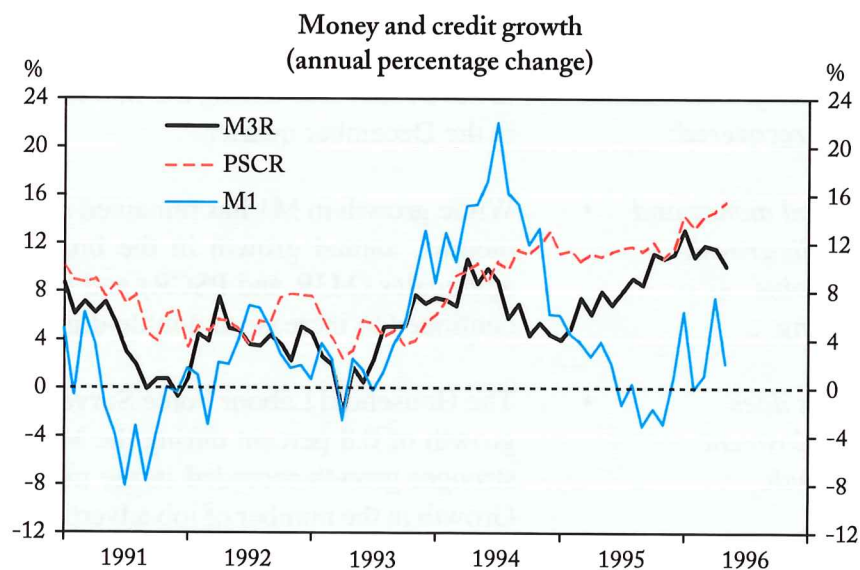
2 Valuation New Zealand house price data for the March quarter is provisional. Quarterly outturns have tended to be revised up when the final statistics are released.

Figure 6



Real GDP: production measure.
 Retail sales: excluding motor vehicle sales and services.
 Employment: HLFS full time equivalent employment.
 Building consents: new houses and flats (June quarter est. based on data for April).

Figure 7



M3R: M3 held by NZ residents; growth rates adjusted for structural breaks.
 PSCR: credit extended to private sector NZ residents.
 M1: notes and coins plus transaction account balances at M3 institutions.

Growth may have slowed during the June quarter.

At this stage there is little published data pertaining to economic activity in the June quarter. The data that are available (such as business and consumer confidence survey data and the Department of Labour's unemployment register), combined with information from our business contacts, strongly suggest that growth in demand has weakened, particularly in the housing market. However, given

the normal lags, we expect that growth during the June quarter will moderate only slightly compared to that expected to be recorded in March.

(ii) Technical assumptions regarding policy

*Our
projections ...*

In order to produce the projections discussed below it is necessary to make a number of assumptions regarding the stance of monetary and fiscal policy, and how this is reflected in monetary conditions.

*... reflect recent
market
conditions, ...*

The starting levels of our assumptions for the nominal trade-weighted exchange rate (TWI) and interest rates reflect the mix of monetary conditions prevailing at the time that the projections were being finalised. Thereafter, we make our normal assumption that the TWI appreciates through the projection period in line with the difference between average expected trade-weighted foreign CPI inflation (2.7 percent per annum) and the midpoint of the Bank's inflation target range (1 percent per annum). Long-term domestic interest rates are assumed to follow the general path of comparable foreign interest rates. Short-term domestic interest rates are assumed to remain at around recent levels over the entire period covered by the projections. Thus:

*... and are
conditional on
the technical
assumptions of ...*

*... a nominal
exchange rate
appreciation ...*

- From a starting point of 64.0 in the September 1996 quarter, the TWI is assumed to appreciate by 1.7 percent per annum, reaching 66.7 by March 1999.³ A 1 percent increase in the exchange rate is assumed to result, around a year later, in a 0.3 percent decrease in consumer prices.

*... and stable
domestic interest
rates.*

- The 90-day bank bill rate is assumed to remain at around 10 percent over the entire period covered by the projections.⁴

These assumptions are technical and illustrative in nature rather than prescriptive. The appropriate *level* of monetary conditions will depend on the extent to which indicators of future inflation are consistent with underlying inflation moving back into the middle part of the target range. The exact *mix* of monetary conditions will depend on decisions made within financial markets.

*Fiscal policy is
assumed to be
consistent with
the 1996 Budget.*

The fiscal policy stance is assumed to evolve in a manner consistent with the 1996 Budget. As usual, we have made an allowance for the extent to which our macroeconomic outlook differs from that underlying the Government's projections. In practice, this mainly

3 The assumed starting point of 64 on the TWI in the September 1996 quarter is slightly below the 64.5 implicit in the March *Economic Projections* but, thereafter, the assumed rate of appreciation is unchanged.

4 The March *Economic Projections* assumed a 90-day bank bill rate of 8.7 percent over the entire projection period.

has implications for our projections of spending on social welfare and debt servicing, and for our projection of revenue from tax collection.

Actual outturns will differ if assumptions are incorrect.

We stress that the projections discussed in this *Statement* are strictly conditional on the above policy assumptions, as well as other assumptions and judgements regarding external influences (for example, world growth and inflation) and the nature of behavioural relationships. They are prepared primarily for use within the Bank to guide the conduct of monetary policy. To the extent that the assumptions and judgements fail to hold, actual outcomes are likely to differ from the projections.

(iii) The economic outlook

Growth of around 2 to 2.5 percent is expected.

On the basis of the technical assumptions outlined above, we now project annual (point-to-point) growth in economic activity of around 2 to 2.5 percent per annum in both the years to March 1997 and March 1998. While the aggregate outlook for the year to March 1997 is little changed from that discussed in the *March Economic Projections*, the outlook thereafter is weaker than previously projected.

Uncertainty surrounds both the current strength of the economy and the key drivers of aggregate demand.

This outlook is complicated by two factors. First, uncertainty exists regarding the current strength of the economy. We have needed to balance data pointing to a resurgence in domestic demand during the December and March quarters with more recent indications of a weakening in consumer and business confidence, and demand, in the June quarter. Second, the key drivers of aggregate demand - the level of monetary conditions, the stance of fiscal policy, developments in consumer and business confidence, actual and perceived future wealth, world economic growth, and the terms of trade - are currently characterised by quite divergent trends. We have weighed up the various influences in judging the likely net effect on aggregate demand.

Increases in household income and wealth have underpinned demand.

One possible explanation of the recent strength of economic activity is that the rebound in domestic demand was solely related to spending in anticipation of the forthcoming tax cuts. In the Bank's view, however, while this may have been a contributing factor, the rebound can mainly be attributed to developments in household income and wealth. Recent employment and wage and salary outcomes have meant a continuation of solid growth in household disposable incomes, while households' willingness to spend is also likely to have been reinforced by the positive impact on household wealth from strong growth in house prices (the latter reflecting households' expectations of further growth in income and house prices). Investor participation in the housing market also appears to have played a role in sustaining demand in the housing

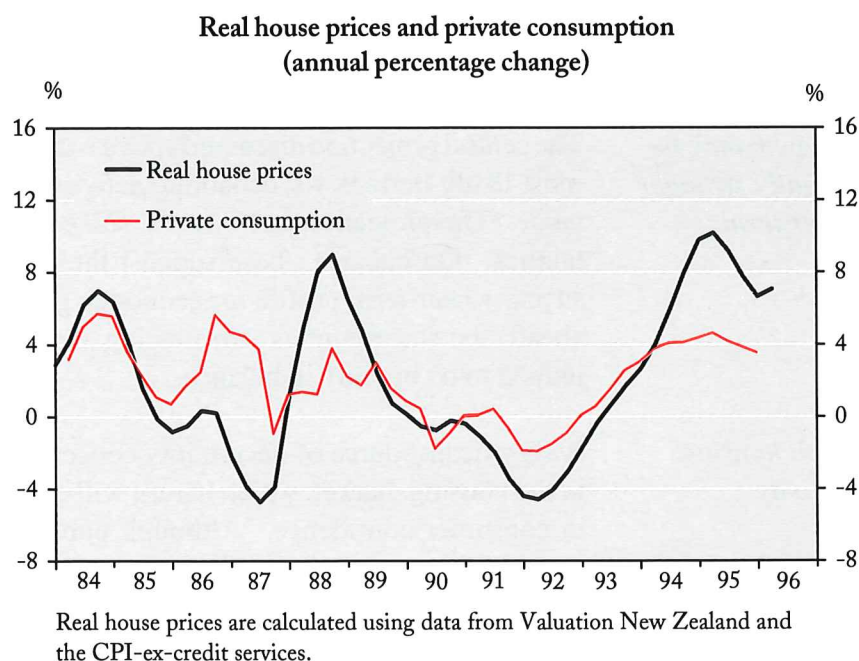
sector, with the ready availability of low fixed rate mortgage funding no doubt a contributing factor.

Firm monetary conditions and uncertainty have dampened confidence, ...

... especially in the housing sector.

However, monetary conditions have remained firm for much longer than most (including the Bank) had expected would be necessary to contain inflation. This factor, combined with increasing uncertainty in the economic and political climate, appears to have resulted, more recently, in a relatively sharp fall in business and consumer confidence. This is revealed in recent developments in the housing market, particularly in Auckland. Information from our business contacts there suggests a sharp fall in demand for new and existing homes, and some decline in house prices (partially reversing some of the extremely steep upward movements recorded over the previous six months). The resulting negative implications for household wealth are, in turn, expected to reinforce a drop in confidence in the household sector, and thus tend to dampen household spending. As discussed above, these projections assume that firm monetary conditions are maintained throughout the period.

Figure 8



The fiscal package will boost incomes

The impact of firm monetary conditions is softened by a loosening of the fiscal policy stance. The Government's fiscal package, the first stage of which will be implemented on 1 July 1996, will provide a direct and sizeable boost to household disposable incomes. All other things being equal, this will tend to lead to stronger growth in household spending, particularly if the tax cuts are perceived to be permanent. This, in turn, can be expected to feed through into stronger spending on investment by businesses than would occur in the absence of tax cuts.

Manufactured exports are expected to increase.

A positive outlook for the world economy is also expected to underpin growth. In particular, a more optimistic outlook for the Australian economy and, to a lesser extent, the impact of the slightly weaker real exchange rate implicit in these projections, point to a stronger rise in manufactured exports than the Bank projected in March.

After weighing up all of the above factors, the Bank's assessment is that the rate of growth of aggregate demand over each of the next two years will be only slightly greater than that experienced in 1995/96, and somewhat below the economy's longer-term sustainable rate of growth. This implies a reduction in excess demand pressures throughout the period (reflected in the projection for inflation discussed in Section V).

The current account will remain broadly stable.

Our projections now indicate a broadly stable current account deficit over the period covered by these projections. The smaller deficit compared with that published in our March *Economic Projections* mainly reflects projected developments in the trade balance - a more favourable outlook for export volumes, weaker growth in import volumes (reflecting weaker domestic demand), and a stronger pick-up in the terms of trade.

(iv) Uncertainties in the projection

Growth may be slightly stronger near term.

The central projection discussed above is the Bank's estimate of the most likely outlook for economic activity *given the assumptions made*. The projection is, however, subject to a number of uncertainties. On balance, these suggest the possibility of a slightly stronger near-term profile for economic growth. Looking further ahead, the uncertainties surrounding the central projection are judged to be broadly in balance.

Both housing activity ...

A significant source of uncertainty concerns future developments in the housing market, which in turn will depend on developments in consumer confidence. Although published data indicate extremely buoyant activity in this sector, more recent evidence suggests that activity has begun to slow quite markedly, indicative of a decline in consumer confidence. The Bank's central projection allows for a decline in activity and a modest fall in prices in this market over the coming year. Picking the turning point in any particular market is always difficult, and the assessment in these projections may prove to be premature. If so, the near-term outlook for economic activity would be stronger than we projected. Alternatively, a more pronounced cycle cannot be ruled out, in which case growth in activity could be weaker.

*... and the impact
of the fiscal
package remain
uncertain*

A second source of uncertainty concerns the impact of the Government's fiscal package on the economy. As discussed above, we have continued to assume that the fiscal package will deliver a sizeable boost to aggregate demand, although not to the extent expected by many economic commentators. On the one hand, the recent decline in household and business confidence, in association with (and partially because of) firmer monetary conditions, raises the chance that we may be overestimating the stimulus from the fiscal package. To the extent that the recovery in domestic demand over December and March reflected spending in anticipation of the tax cuts, this would raise the probability of a more muted spending response by households once the tax cuts are delivered. On the other hand, confidence in the longer-term prospects for the economy could see a stronger spending response by households than we have assumed.

*Risks surround
the outlook for
world growth*

Finally, in line with our normal approach, our assumptions about the world economic outlook (and more specifically, that for our trading partners) are based on international *Consensus* forecasts. In the Bank's view, these forecasts are currently subject to an element of risk, with the possibility of stronger economic growth over the next year, and weaker economic growth thereafter.

V. Inflation: recent developments and outlook

Annual underlying inflation exceeded the target range in March ...

Upward pressures on inflation have been evident since the beginning of 1994. These pressures, reflecting an expansion of demand beyond the sustainable productive capacity of the economy, resulted in annual underlying inflation rising above the Bank's 0 to 2 percent target range in the June 1995 quarter, and again, more recently, in the March 1996 quarter.

... and is likely to remain above 2 percent for the remainder of 1996, ...

Our revised projections suggest that the near-term outlook for inflation has deteriorated significantly since we published the March 1996 *Economic Projections*. This substantially reflects continued price increases in the housing-related sectors of the economy, and reflects strong growth in unit labour costs. Annual underlying inflation is now projected to remain above the Bank's target range over the remainder of 1996.

... after which it is projected to fall rapidly.

Thereafter, we project underlying inflation to decline rapidly. This stems from both falling import prices and increasing levels of spare capacity in the economy (the latter reflects our projection that economic growth will be weaker than the longer-term sustainable rate). Indeed, *on the basis of the technical assumptions made*, underlying inflation would most likely undershoot the Bank's target range by the end of the period covered by these projections.

(i) Recent inflation developments

The Bank calculates and publishes a measure of inflation - underlying inflation - which seeks to reflect the intent of the *Policy Targets Agreement*. The calculation entails excluding both the impact of changes in interest rates and one-off shocks to the price level (such as those associated with movements in government charges and international commodity prices) from the official (headline) CPI. The Bank focuses on the outlook for underlying inflation when determining the required monetary policy stance.

Underlying inflation outcomes have continued to remain inconsistent with the Bank's objective of maintaining inflation in the middle part of the target range.

Underlying inflation

The March outturn was marginally higher than projected ...

The underlying increase in consumer prices was 0.6 percent in the March 1996 quarter, 0.1 percent higher than projected by the Bank in the March *Economic Projections*. As a result, underlying inflation over the year to March rose above the Bank's target range, reaching 2.1 percent, compared with 2.0 percent in the year to December 1995.

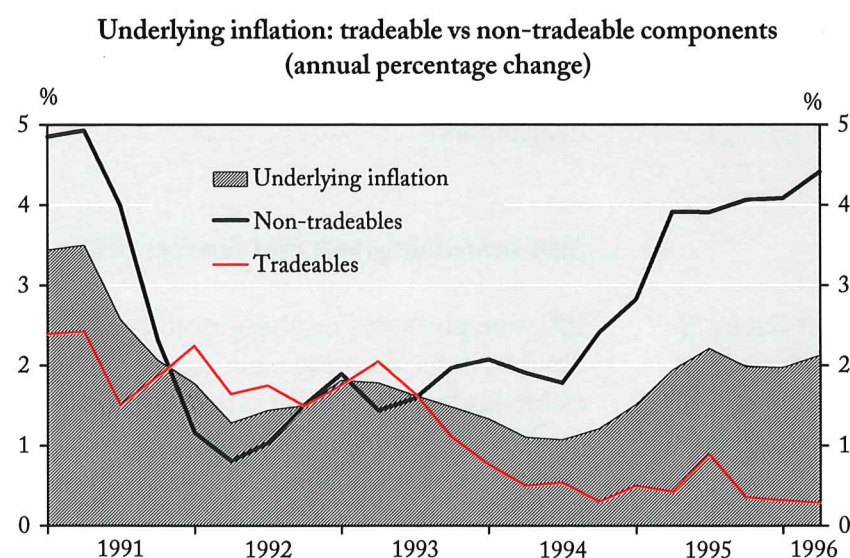
... reflecting demand pressures ...

The persistence of an undesirably high rate of underlying inflation - both in the recent past and in our near-term projections - reflects a number of factors. Demand has been stronger than expected and excess demand pressures now seem likely to remain positive for somewhat longer than the Bank had projected in March, leading to a more extended period of upward pressure on inflation and inflation expectations. At the same time, and perhaps more importantly, the extent of inflation pressure accompanying that level of excess demand has been higher than expected, most noticeably in the housing sector, but also across the remainder of the non-tradeables sector. Less obviously, excess demand conditions may also have allowed importers and distributors to widen their profit margins, with the result that the exchange rate pass-through has been weaker than would be expected across the average of the economic cycle.

... and increased government charges.

Increases in government charges (specifically, tertiary fees and excise tax on loose leaf tobacco) made a sizeable contribution to underlying inflation in the quarter. However, when considered jointly with movements in other government charges over the past year, these influences failed to reach the Bank's usual 'materiality' threshold (a contribution of 0.25 percentage points to annual inflation). These influences were not, therefore, removed from headline inflation for the purpose of calculating underlying inflation.

Figure 9



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.

Tradeable goods and services prices

World prices ...

New Zealand is generally a price-taker in the markets for most internationally traded goods and services. Thus, the prices of many goods and services in New Zealand are largely determined abroad, rather than by demand and supply conditions in New Zealand.

... have remained stable overall.

Following a very sharp increase in the second half of 1994/95, the ANZ Commodity Price Index suggests that the world price of New Zealand's commodity exports has been relatively stable over the last year or so, with sharp falls in the price of some commodities (such as beef) offset by sharp rises in the price of others (such as dairy products). At the same time, movements in the implicit aggregate world price of New Zealand's non-commodity exports and imports have remained relatively stable reflecting generally modest inflation rates in the economies of our major trading partners and, in the case of imports, continued gains by firms in cheaper sourcing of products.

Exchange rate appreciation has led to less downward price pressure than expected.

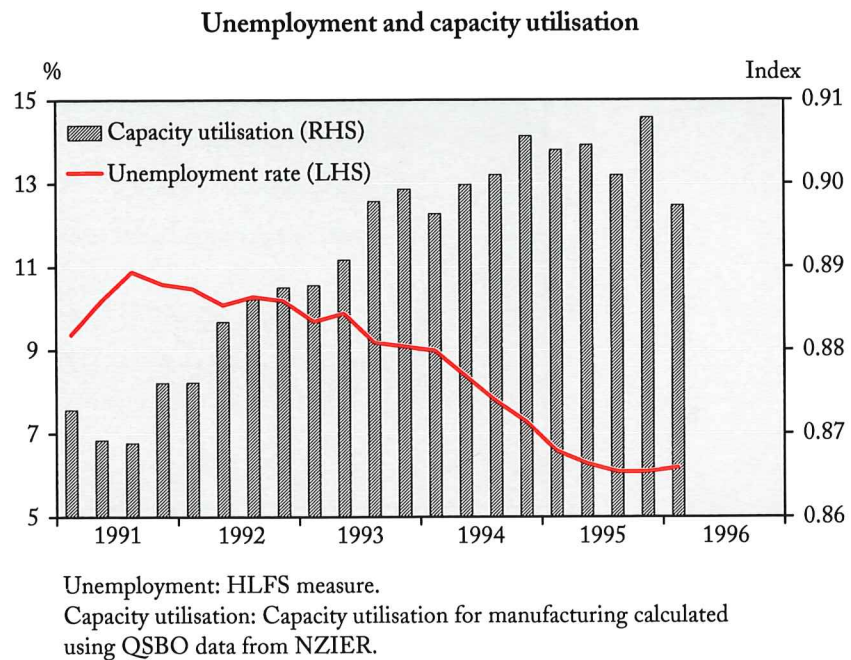
Combining these world price influences with the sharp appreciation of the nominal exchange rate over the last three years, given the usual exchange rate pass-through coefficient, one might have expected to see a fall in the domestic prices of tradeable goods and services. While tradeable goods and services prices fell by 0.1 percent in the March quarter, they increased in underlying terms by 0.3 percent in the year to March, and by 0.6 percent if one excludes the impact of recent falls in fresh fruit and vegetables prices (which reflect improved domestic growing conditions following a poor 1994/95 growing season). This outcome suggests some growth in overall unit profit margins over the period (information from our business contacts has suggested that excess demand conditions may have allowed a widening of profit margins by importers and distributors).

Non-tradeable goods and services prices

Non-tradeable inflation has increased substantially, ...

Inflation pressures resulting from excess demand have been most obvious in the non-tradeable goods and services sector. The Bank estimates that underlying inflation in this sector was 1.6 percent in the March quarter, and 4.4 percent over the year to March 1996. Inflation in the housing sector has continued at particularly high rates. Construction costs increased by 2 percent in the March quarter, and by 5.8 percent over the year to March 1996. Similar increases were recorded in a slightly broader measure of housing-related goods and services.

Figure 10



... not only due to the housing sector, but as a result of excess demand pressures in general.

The impact of rising house prices on household wealth, and thus spending activity, is also likely to have been a contributor to inflation across the broader economy. Although most attention has focused on inflation in the housing sector, the prices of other non-tradeable goods and services have also been rising quite rapidly - by 3.3 percent over the year to March 1996. While a portion of this outcome can be traced to increases in government charges, the majority is simply the manifestation of excess demand pressure.

Figure 11

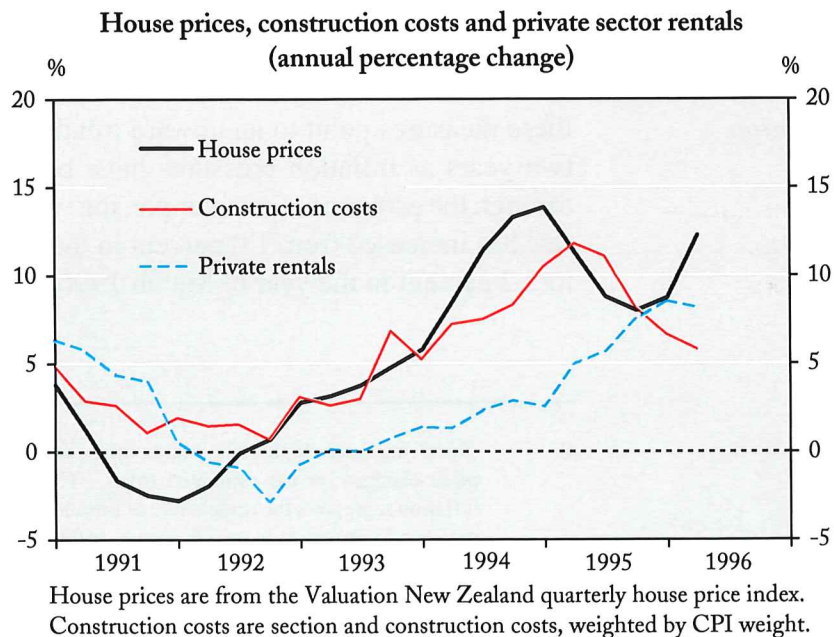
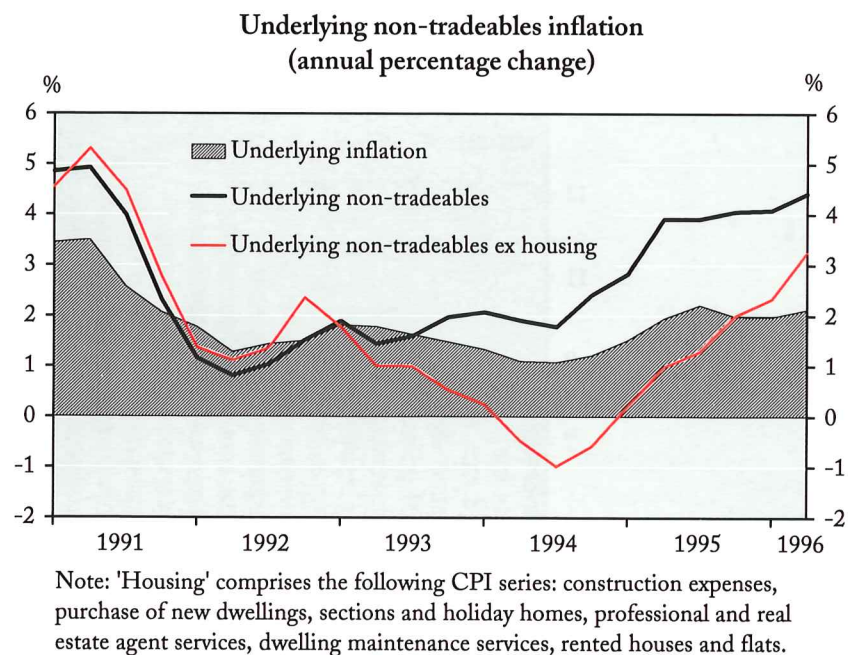


Figure 12



Other measures of trend inflation

The Bank calculates other measures of inflation ...

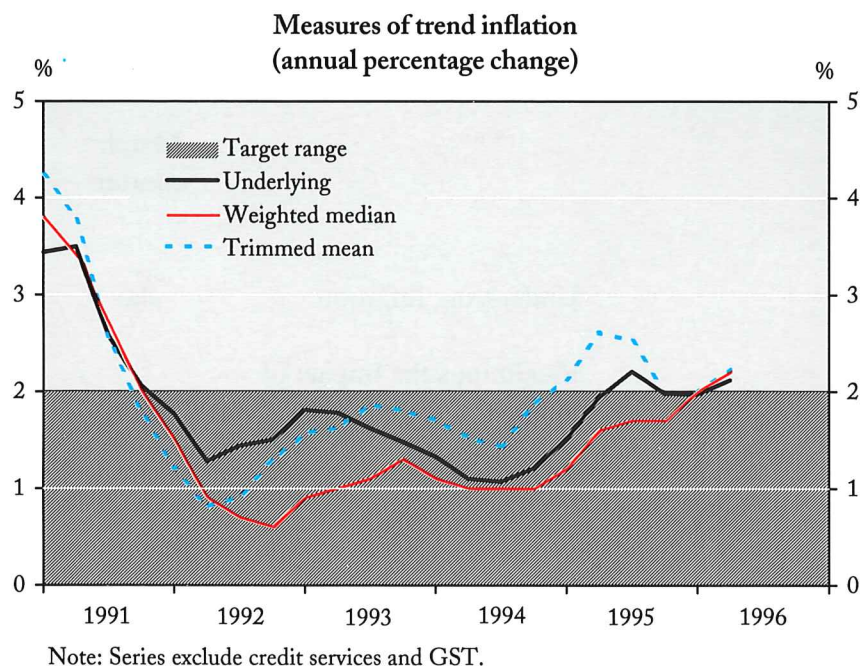
The Bank also monitors a range of alternative measures of trend inflation. Some measures, such as the series for underlying tradeable and non-tradeable inflation discussed above, allow the Bank to get a better understanding of inflation in particular sectors of the economy. Others, such as the weighted median and the trimmed mean, are constructed to provide alternative measures of trends in aggregate inflation.¹ Unlike the Bank's measure of underlying inflation, these alternative measures do not involve substantial elements of judgement in excluding the effects of exceptional price movements.

... which also show rising trend inflation.

Recent inflation outcomes for these series, together with the Bank's measure of underlying inflation, are illustrated in Figure 13. All of these measures point to an upward trend in inflation over the last two years as inflation pressures have become more generalised through the economy. For example, the weighted median inflation rate has increased from 1.0 percent in the year to September 1994 to 2.2 percent in the year to March 1996.

¹ These measures employ alternative methods to reduce the impact of outlying price changes on the estimated trend. The weighted median measure of inflation represents the middle rate of inflation in the sense that half of the CPI regimen experiences increases above, and half below, the median rate. The trimmed mean is computed by removing the components accounting for the largest 5 percent of price increases and the largest 5 percent of decreases each quarter, and computing the arithmetic mean of the remaining components. Each of these measures is based on the CPI ex-credit series. For further discussion see S. Roger (1995) "Measures of underlying inflation in New Zealand, 1981-1995", Reserve Bank discussion paper G95/5.

Figure 13



Headline inflation

Annual headline inflation fell.

The headline CPI increased by 0.5 percent in the March 1996 quarter, 0.1 percentage points higher than the Bank projected in March. As a result, the headline inflation rate fell to 2.2 percent in the year to March compared with 2.9 percent in the year to December 1995. The 0.1 percentage point projection error reflected the stronger-than-expected outturn for underlying inflation.

The increase in government charges was not sufficient to invoke the caveat.

Table 1 accounts for the difference between headline and underlying inflation in both the March quarter and the March year. As the table shows, changes in credit costs account for the entire difference between the two measures over the March quarter, with no exclusions made from headline inflation to reflect government charges, oil prices, or any other caveatable influence. The difference over the March year reflects a small exclusion related to oil prices in the June 1995 quarter. Increases in government charges are estimated to have contributed 0.23 percentage points to CPI ex-credit inflation in the year to March 1996 - below the usual threshold required before we remove their impact when calculating underlying inflation.

Table 1**Reconciliation of underlying and headline CPI inflation to March 1996 (percent changes)**

	March quarter	Year to March
Underlying inflation	0.6	2.1
Plus/minus the impact of interest rates	-0.1	0.0
Plus/minus the impact of government charges	0.0	0.0
Plus/minus the impact of oil price movements	0.0	+0.1
Headline CPI	0.5	2.2

(ii) The near-term outlook for inflation

*The Bank's
inflation
projections ...*

The Bank's projections for the inflation outlook over the June and September quarters are primarily based on a component by component analysis of the prices of the goods and services measured in the CPI. This approach takes into account recent trends, established seasonal patterns, leading indicators, and other specific information gathered from a wide variety of sources. Thereafter, the Bank makes use of both structural and time series statistical techniques which seek to explain overall inflation in terms of more fundamental determinants. These influences include unit labour costs and profit margins (representing the impact of excess demand), and the prices of internationally traded goods and services.

*... point to
higher inflation
outturns over the
near term ...*

The components-based projections point to a substantial deterioration in the near-term inflation outlook compared with that published in March. This reflects both a reappraisal of trends in the light of forecast errors made in previous projections, and new information that has come to hand over the last three months. Based on this analysis, we now expect underlying inflation to be 0.7 percent in the June quarter and 0.6 percent in the September quarter. Our medium-term projections (discussed in detail below) indicate a rapid fall in inflation outcomes thereafter. As a result, underlying inflation is projected to peak at 2.6 percent in the year to September 1996.

... stemming from the housing sector and a range of other goods and services.

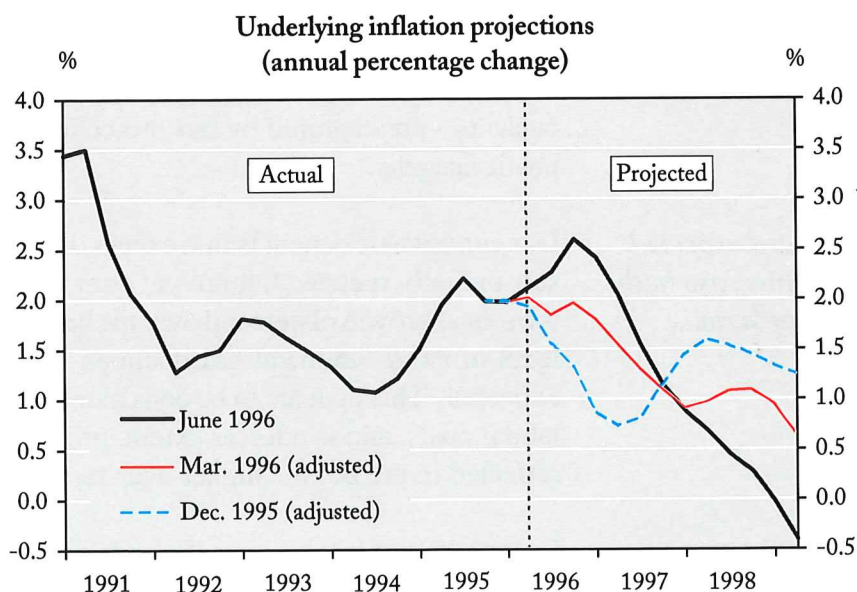
This significant upward revision to our projections for the June and September quarter (0.3 percentage points and 0.2 percentage points respectively) substantially reflects a more pessimistic assessment of near-term inflation in the housing sector (while activity in the housing market is slowing, this will be reflected in measured inflation outcomes with a lag). However, it also reflects stronger price increases for a range of other goods and services. These include food, leisure and recreational goods and services, public transport, and a variety of household supplies and services. Estimates derived from the alternative statistical techniques discussed above - which point to continued excess demand pressures on inflation - support this assessment of the near-term outlook.

(iii) The medium-term outlook for inflation

Inflation is projected to fall rapidly from December onwards.

While the near-term outlook for inflation is significantly higher than that published in the March *Economic Projections*, the medium-term outlook is lower than previously projected. Our current projections show underlying inflation falling rapidly towards the middle part of the target range from the December 1996 quarter onwards, mainly reflecting declines in the price of imported goods, supported by an easing of domestic inflation pressures. Indeed, in the absence of an easing in monetary conditions at some point over the next year, the projections indicate that underlying inflation would most likely undershoot the Bank's target range by the end of the period.

Figure 14



Note: For reasons of comparability, previous projections have been adjusted to bring them on to the same exchange rate tracks as used for the June 1996 projection.

External price influences

The outlook for the foreign currency prices of New Zealand's exports and imports is now slightly weaker than projected in March, particularly over the next year.

Changes in world prices have had little impact on the domestic prices of non-commodity imports.

In past projections, we have related movements in the world price of New Zealand's non-commodity import prices to movements in producer prices in the major world economies. However, taking exchange rate movements into account, this approach has tended to overstate the implicit world prices faced by New Zealand. Further analysis has shown that movements in a weighted average of the USD/NZD and Yen/NZD nominal exchange rates are the dominant influence on the domestic price of non-commodity imports, implying that the impact of world price movements has been negligible over the last decade. This may reflect ongoing gains made in sourcing lower cost goods as firms have become more outward looking. Our assumption is that this behaviour will continue.

Over the short term, commodity prices are expected to decline while oil prices increase.

Non-oil commodity prices are assumed to retain their historical relationship with growth in OECD industrial production. Recent revisions to *Consensus* forecasts of overseas industrial production suggest a decline in commodity prices over the year to March 1997, and a modest recovery thereafter. Our assumption for world oil prices has been revised up over the short-term, and down further out, in line with *Consensus* forecasts of the USD price of Dubai crude.

Domestic influences

Unit labour costs ...

The influence of inflation pressures generated predominantly in the domestic economy - reflecting strains on the economy's productive capacity - are captured by our projection of unit labour costs and profit margins.

... are expected to increase in the near term, ...

Our current assessment is that excess demand pressures have been substantially reduced but not yet completely eliminated. Indeed, the robust growth of demand over the last six months means that the level of excess demand has declined by less than the Bank had expected. This appears to be consistent with strong growth in unit labour costs, and to a lesser extent, profit margins. In turn, this is reflected in the Bank's higher near-term projections for inflation.

... due to increases in wages and salaries ...

Growth in unit labour costs depends on movements in wages and salaries as well as labour productivity. The most recent statistics indicate that wage and salary settlements have been slightly higher than the Bank had expected. The Quarterly Employment Survey measure of private sector hourly wage rates recorded an increase of 3.6 percent in the year to February 1996. The Labour Cost Index,

which we interpret as an imperfect measure of unit labour costs, rose 1.9 percent over the same period.

... and declining labour productivity.

Our estimate of GDP growth for the March 1996 quarter, together with hours worked data from the Household Labour Force Survey, points to a further decline in labour productivity. We interpret this to reflect cyclical factors, rather than indicating a reduction in the trend rate of growth below that assumed in these projections (the risks surrounding this assumption are discussed later in the section). Given persistent skill shortages, firms appear to have been happy to retain and, where possible, continue to recruit skilled and semi-skilled labour, beyond that consistent with short-term growth in demand. This behaviour is likely to have reflected firms' expectations of a lift in demand in response to the government's fiscal package, a more optimistic outlook for world growth, and an easing of monetary conditions at some point in the near future. Therefore, a period of relatively weak employment growth and a correspondingly strong pick-up in productivity growth is projected during 1997.

Further ahead, both growth in unit labour costs and profit margins are projected to decline ...

Taken together, recent movements in wage and salaries and productivity imply strong growth in unit labour costs. To the extent that the increase in unit labour costs is perceived to be temporary, firms will be much less likely to raise their selling prices. In this case, firms' profit margins will act as a buffer. Consequently, our projection of inflation assumes that the full increase in unit labour costs will not be passed through into selling prices. Looking further ahead, declining excess demand pressure is projected to result in much weaker growth in unit labour costs, and a decline in profit margins.

... and housing-related inflation pressures will weaken.

Finally, as noted in Section IV, the Bank's projections anticipate a slowdown in activity in the housing market, accompanied by a modest fall in house prices. Based on past historical relationships this will result in some downward pressure on construction costs, and housing-related expenses more generally.

Inflation expectations

Survey data suggest short-term inflation expectations may have peaked ...

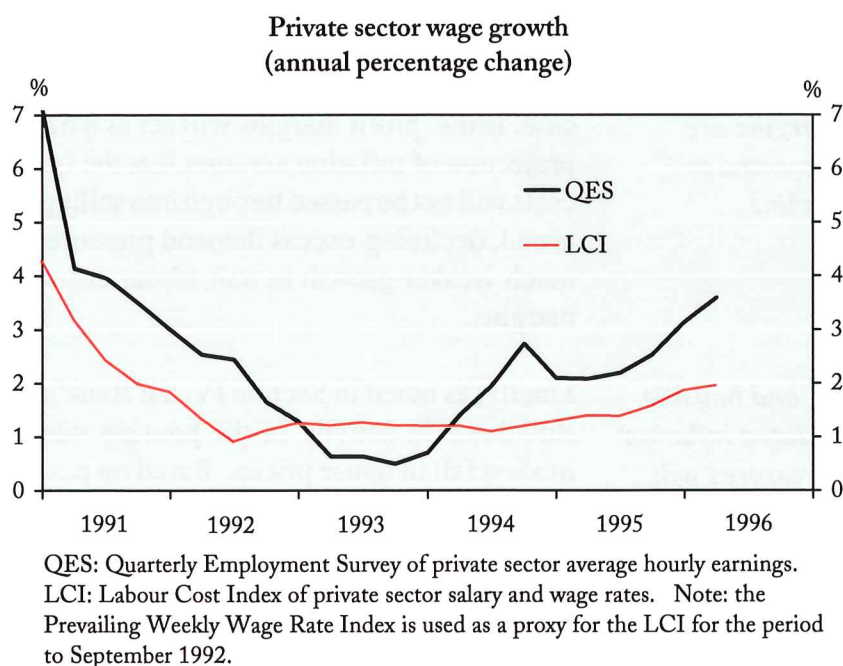
The Bank monitors a range of surveys recording the inflation expectations of firms, households, and financial sector participants. This is because expectations of future inflation are themselves an important determinant of wage and price setting behaviour. While recent surveys suggest that short-term inflation expectations may have peaked, at this stage there is little evidence that either firms or households expect a rapid fall in inflation.

... but there is no sign as yet of a firm downturn.

- The National Bank's May Business Outlook survey indicated one-year-ahead inflation expectations of 2.6 percent, little changed from that expected over the previous six months, although the net balance of firms expecting to raise prices continues to fall. The Reserve Bank's May *Survey of Expectations* indicated that one and two-year-ahead expectations of annual underlying inflation were 1.6 percent and 1.5 percent, respectively, unchanged from February.
- The May Marketscope survey of households' expectations indicated that one-year-ahead inflation expectations, although down for the second consecutive quarter, remained high at 3.6 percent, compared with 4.2 percent in November 1995.

Economists' longer-term expectations of inflation remained broadly unchanged at around 1.4-1.5 percent according to the Alexander Consulting Group survey for April.

Figure 15



Inflation projections

On the basis of the technical assumptions made, the outlook for the real economy discussed in Section IV, and the various other influences on inflation discussed above, the Bank's latest projections for underlying inflation is shown in Table 2 and Figure 14. 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.
1995						
Mar.	0.5	1.9	0.5	2.6	1.2	4.0
June	0.6	2.2	0.6	2.7	1.0	4.6
Sept.	0.3	2.0	0.3	2.1	0.2	3.5
Dec.	0.6	2.0	0.6	2.0	0.6	2.9
1996						
Mar.	0.6	2.1	0.6	2.2	0.5	2.2
June	0.7	2.2	0.7	2.3	0.8	2.1
Sept.	0.6	2.6	0.6	2.6	0.7	2.6
Dec.	0.4	2.4	0.4	2.4	0.4	2.4
1997						
Mar.	0.3	2.0	0.3	2.0	0.3	2.2
June	0.2	1.5	0.2	1.5	0.2	1.5
Sept.	0.2	1.1	0.2	1.1	0.2	1.0
Dec.	0.1	0.9	0.1	0.9	0.2	0.8
1998						
Mar.	0.1	0.7	0.1	0.7	0.0	0.6
June	0.0	0.5	0.0	0.5	0.0	0.4
Sept.	0.1	0.3	0.1	0.3	0.1	0.3
Dec.	-0.2	0.0	-0.2	0.0	-0.2	-0.1
1999						
Mar.	-0.3	-0.4	-0.3	-0.4	-0.3	-0.4

*Underlying
inflation will
re-enter the
target range in
March 1997 ...*

The projections for the June and September quarters of 1996 have already been discussed. Looking further ahead, underlying inflation is projected to remain above the 0 to 2 percent target range in the year to December, before narrowly re-entering the target range in the year to March 1997. Annual underlying inflation is projected to fall rapidly thereafter and, on the basis of the technical assumptions made, would most likely undershoot the Bank's target range by the end of the period covered by the projections.

... reflecting falls in imported goods prices and declining excess demand pressures.

In addition to the direct impact of higher construction costs, the persistence of inflation over the year to March 1997 reflects an upward revision to our projection for unit labour costs, offset to some extent by a stronger fall in the domestic price of imported goods. Relatively low quarterly inflation outturns translate into a fall in annual underlying inflation over 1997/98. This substantially reflects a continuation of a declines in foreign prices and the assumed appreciation of the nominal exchange rate. A weakening of inflation pressures stemming from domestic unit labour costs and profit margins, and in housing-related factors measured in the CPI, also contribute to lower inflation outcomes.

Medium-term projections are lower than those published in March.

The fall in inflation is more pronounced in these projections compared with those published in March. The slight downward revision to underlying inflation in the year to March 1998 mainly reflects our assessment of lower inflation from import prices and building costs, offset to some extent by less downward pressure from excess demand. The more substantial downward revision in the year to March 1999 reflects the significant downward pressure on inflation that is projected to stem from the accumulation of greater slack in the economy during 1997/98 and 1998/99. The latter results from our technical assumption that monetary conditions remain firm (both in absolute terms and relative to the March *Economic Projections*), even as the fiscal stimulus passes.

Both headline and underlying inflation should follow similar paths.

The path of headline inflation is projected to closely follow that of underlying inflation. Headline inflation will exceed underlying inflation in the June 1996 quarter solely reflecting the impact of recent increases in mortgage interest rates. Thereafter, our assumption of no further movement in credit costs, combined with our projection of no adjustments to reflect either international commodity prices or government charges, means that our quarterly projections for headline and underlying inflation are the same.²

(iv) Uncertainties in the projections

Projections are subject to uncertainty - ...

The projections discussed in this *Statement* represent the Bank's best estimate of the outlook for underlying inflation *conditional on the technical assumptions made*. This outlook is, however, subject to a range of uncertainties. Some of these relate to the risks surrounding the outlook for aggregate demand. Others relate to the Bank's assessment of the level of spare capacity in the economy. Finally, there are several uncertainties regarding the inflation

2 The slightly uneven nature of the profile for headline inflation relative to that for underlying inflation reflects the impact of rounding. The slight downward drift in the annual headline inflation projection relative to that for underlying inflation is the result of the impact of our assumption of no movement in measured credit costs (included in the headline inflation rate but not in the underlying inflation rate) beyond the June 1996 quarter.

outlook which are less dependent on the path of demand and supply in the domestic economy.

... the near-term risks are on the upside, but evenly balanced further out.

Overall, taking into account all sources of uncertainty, it is the Bank's assessment that the risks surrounding the outlook for inflation over the coming year are slightly on the upside. Further out, the risks are considered to be evenly balanced, reflecting the distribution of risks to our projection of the real economy. The key uncertainties under each of these headings are discussed below.

Uncertainties related to the outlook for aggregate demand

In the near term the economy may be stronger ...

The key uncertainties surrounding the outlook for aggregate demand were discussed in Section IV. To summarise, in the near term, the balance of risks suggests the possibility of a stronger real economy outlook than that presented in this *Statement*. Over the medium term, the risks surrounding the projection are judged to be broadly in balance.

... leading to less downward pressure on inflation.

To the extent that risks are realised and aggregate demand and production in the economy proves to be stronger than contained in these projections, *all other things being equal*, the extent of downward pressure on inflation will be correspondingly weaker. The converse would apply if aggregate demand pressures prove weaker than projected.

Uncertainties related to the Bank's assessment of potential output

In addition to projections of aggregate demand, estimates of excess demand also require an assessment of the economy's sustainable productive capacity (potential output), and its future evolution.

The Bank uses a variety of measures of potential output ...

As noted in the December 1995 *Monetary Policy Statement*, the measurement of the potential output - both current and future - is subject to considerable uncertainty. Alternative empirical measures of potential output can sometimes lead to different qualitative and quantitative conclusions regarding the level of spare capacity in the economy. For this reason, rather than rely on any single measure, the Bank analyses a number of indicators of excess demand when forming its view regarding the level of spare capacity in the economy.

... however, these measures are subject to uncertainty.

Even greater uncertainty prevails when one tries to extend these measures into the future. The evolution of potential output through time depends fundamentally on the rate of growth of the labour force and productivity. While, in many countries, history can provide a reasonably reliable guide to the economy's future growth

rate, history is much less likely to be a reliable guide in New Zealand. This reflects the still uncertain longer-term impact of more than a decade of economic and financial reform. The uncertain impact of forthcoming changes in tax and benefit abatement rates on labour force growth and productivity is simply the most recent example of factors which complicate such calculations.

That said, in observing recent trends in productivity growth the Bank has seen little evidence, at this stage, to suggest that the economy's potential growth rate is currently greater than 3 percent per annum (3 percent being the assumption adopted in these projections). To the extent that the Bank is overestimating the economy's potential growth rate, *all other things being equal*, the extent of downward pressure on underlying inflation will be less than depicted in these projections.

Other sources of uncertainty

There are a number of other uncertainties surrounding the inflation outlook that are less dependent on evolution of demand and supply in the economy.

The exchange rate pass-through is subject to considerable uncertainty.

Uncertainties related to the degree of pass-through from the nominal exchange rate to the domestic price level continue to pose one of the most significant risks to the inflation outlook. The degree of downward pressure on tradeable goods and services prices in response to the appreciation of the nominal exchange rate has been weaker than would have been expected given past historical relationships. This may suggest that previous relationships are no longer valid and that the true pass-through coefficient is lower than that currently assumed by the Bank. In this case, the extent of downward pressure coming from the appreciation of the nominal exchange rate during the first half of 1996, and from projected falls in world commodity prices over the next year, would be weaker than allowed for in these projections. Alternatively, the lower pass-through may reflect a temporary build-up in firms' profit margins due to exceptionally strong demand. This would admit the possibility that further disinflationary pressure may occur as excess demand pressures in the economy ease.

Housing sector inflation may fall off more markedly than projected.

Inflation in the housing market also remains a risk, both because of its impact on demand, and thus generalised inflation, and more directly because of its impact on goods and services captured explicitly in the Consumer Price Index. A substantial portion of the upward revision to underlying in the June and September quarters can be attributed to sharper increases in construction costs. If the housing market were to slow more sharply than we have assumed, it is possible that the near-term path for construction costs could be weaker than we have assumed.

In addition ...

Three other uncertainties also impinge on the inflation outlook:

... expectations of inflation could deteriorate, ...

- The inflation expectations of price setters in the economy could be raised as a result of inflation remaining outside the Bank's target range for an extended period. This would, in turn, raise the likelihood of an even more protracted departure, and raise the social and economic cost of returning inflation back within the target band. This risk underlies the Bank's desire to see inflation return quickly to the middle part of the target range.

...world economic growth could be weaker, ...

- To the extent that the world economic growth proves weaker than assumed in these projections, world prices for New Zealand's commodity and non-commodity tradeable goods could also be weaker.

... and the mix of monetary conditions could be different than projected.

- A rebalancing of monetary conditions in favour of higher interest rates and a relatively lower exchange rate could occur in response to expectations regarding either post-election economic policy or trends in the current account deficit. This would tend to lead to temporarily higher inflation outcomes due to the direct price level effects stemming from a movement in the nominal exchange rate, offset to some extent by lower asset prices.

Appendix 1: Chronology

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

1995

- 14 December: The Reserve Bank released its thirteenth *Monetary Policy Statement*.
- 19 December: The US Federal Reserve cut the Federal funds rate by 25 basis points to 5.5 percent.
- 20 December: The Chairman of the non-executive Directors of the Reserve Bank, Sir Peter Elworthy, wrote to the Minister of Finance, the Right Honourable W F Birch. He re-affirmed the view of the non-executive Directors regarding the nature of the target established by the Policy Targets Agreement. The text of this letter is reproduced in Appendix 2.

1996

- 17 January: The December quarter CPI outcome was released. Headline inflation for the year to December 1995 was 2.9 percent. The annual rate of underlying inflation was estimated at 2.0 percent.
- 31 January: The US Federal Reserve cut the Federal funds rate by 25 basis points to 5.25 percent.
- 21 March: The Reserve Bank released its March *Economic Projections*.
- Continued stress on the economy's productive capacity, together with pressure in real estate markets, were the most significant factors influencing the Bank's near-term inflation outlook. Underlying inflation for the years to September 1996 and 1997 was projected to be 1.9 and 0.8 percent, respectively.
- The Reserve Bank Governor, Dr Don Brash, said "there is no room for any easing in monetary conditions, relative to those assumed in the projections, for some time to come". Dr Brash noted that the Bank's firm monetary policy stance reflected the conviction that the best thing the Bank could do was to continue to build confidence that low inflation was here to stay.
- 2 April: GDP production figures were released showing the New Zealand economy had grown by 2.4 percent in the year to December 1995.
- 17 April: The March quarter CPI outcome was released. Headline inflation in the year to March was 2.2 percent. The annual underlying rate of inflation was estimated at 2.1 percent.

18 April: In light of underlying inflation breaching the upper end of the 0 to 2 percent target range, the Minister of Finance wrote to the non-executive Directors of the Reserve Bank. He sought their assessment of the performance of the Reserve Bank Governor, under the Policy Targets Agreement signed in December 1992. The text of this letter is reproduced in Appendix 2.

19 April: Sir Peter Elworthy, Chairman of the non-executive Directors of the Reserve Bank, wrote to the Minister of Finance regarding the performance of the Reserve Bank Governor. The text of this letter is reproduced in Appendix 2.

The Governor of the Reserve Bank, Dr Don Brash, also wrote to the Minister of Finance, explaining why the breach of the inflation target range had occurred. The text of this letter is also reproduced in Appendix 2.

Appendix 2: Correspondence

Letter from Sir Peter Elworthy, Chair, non-executive Directors of the Reserve Bank to the Minister of Finance, the Right Honourable W F Birch
20 December 1995

“The non-executive Directors of the Reserve Bank met independently of the Governor and Deputy Governors on 14 December 1995. The meeting followed the December Board meeting, which was held concurrent with the release of the December 1995 *Monetary Policy Statement*.”

“The meeting noted that the Bank is forecasting underlying inflation for the years to December 1995 and March 1996 at 2.0 percent and 1.9 percent respectively, and that the projected path for underlying inflation is now expected to remain uncomfortably close to the top of the Bank’s 0 to 2 percent target range over the year to September 1996. Thereafter, underlying inflation is projected to re-enter the middle part of the target range, before rising slightly to 1.6 percent in the year to March 1998. There is obviously some risk that underlying inflation will exceed 2.0 percent over the coming months.”

“The non-executive Directors wish to re-affirm the view expressed in their letter to you dated 29 June 1995 regarding the nature of the target established by the Policy Targets Agreement. In particular, they wish to re-affirm that it is their “understanding that 0 to 2 percent was always intended to be a target towards which the Bank would be *constantly aiming*, not necessarily a target which could, given the inevitable uncertainties in forecasting and lags in the effectiveness of monetary policy, always be certain of attainment”.”

“They also wish to re-affirm that the Governor’s performance is endorsed as being very successful over the period since the first Policy Targets Agreement was signed and that a marginal breach above or below the 0 to 2 percent inflation target is not, in their opinion, considered a matter which should call into question the Governor’s performance or his continued employment.”

Letter from the Minister of Finance to Sir Peter Elworthy
18 April 1996

“As you know, the Reserve Bank announced yesterday that underlying inflation in the year to March 1996 was 2.1%. According to the Bank’s measure this appears to constitute a breach of the 0-2% target range outlined in the Policy Targets Agreement (PTA).”

“I regard any breach of the target range as serious. Our Government is committed to a policy of price stability, and we rely on the Reserve Bank to provide this, under the guidance of the Governor.”

“Accordingly, following the procedure that we have established in the event of a breach of the target range, I am seeking your views on:

- What factors led to the breach of the target range?

- What action is the Governor taking to direct inflation back to within the target range?
- Are the current actions put in place by the Governor adequate to ensure a return to price stability?"

"I would like to receive your advice as soon as possible and certainly within the next few days."

"I am sending a copy of this letter to the Governor for his information."

Letter from Sir Peter Elworthy to the Minister of Finance

19 April 1996

"In response to your press release of 17 April and your letter of 18 April 1996, the non-executive Directors of the Reserve Bank met independently of the Governor and Deputy Governors on 18 April 1996, following the April Board meeting."

"The non-executive Directors regret the 0 to 2 percent underlying inflation target range has been breached for the second time. We note this breach of 0.1 percent is a very small one, significantly contributed to by Government charges totalling 0.23 percent. This very small breach, on its own, should not call into question the Bank's absolute commitment to ongoing price stability for New Zealand. Nevertheless, we regard any breach of the 0 to 2 percent range as a matter for considerable concern, no matter how small nor how temporary the breach."

"The meeting also noted that the Bank's March 1996 *Economic Projections* are for underlying inflation to decline to 1.3 percent by March 1997, to 0.9 percent by March 1998, and to 0.6 percent by March 1999. In this context, non-executive Directors expect the Bank to continue to respond to the still strong inflationary pressures in a vigilant and determined way."

"You will recall that non-executive Directors advised you on 20 December 1995 that "there is obviously some risk that underlying inflation will exceed 2.0 percent over the coming months". We also noted in our letter to you that it continues to be our "understanding that 0 to 2 percent was always intended to be a target towards which the Bank would be *constantly aiming*, not necessarily a target which could, given the inevitable uncertainties in forecasting and lags in the effectiveness of monetary policy, always be certain of attainment".

"Non-executive Directors further re-affirmed then that "the Governor's performance is endorsed as being very successful over the period since the first Policy Targets Agreement was signed and that a marginal breach above or below the 0 to 2 percent inflation target is not, in their opinion, considered a matter which should call into question the Governor's performance or his continued employment".

"The Governor's performance must still be regarded as of the highest order by international standards. He continues to have the non-executive Directors' unanimous and total support."

“In your letter of 18 April 1996 you sought our views on three specific questions. The Governor is responding to your first two questions as they are the same as the first two questions addressed to him in your press release of 17 April 1996, and we consider that is appropriate. The non-executive Directors are aware of the Governor’s response and are in agreement with it. Our response to your third question, asking whether current actions put in place by the Governor are adequate to ensure a return to price stability, is as follows:”

“Based on the evidence available to us at this time, we have no reason to doubt that actions taken to date are adequate to ensure a return to ongoing price stability. It is noteworthy that most market commentators are suggesting that, if anything, current conditions are rather tighter than is required to return the underlying inflation rate to the middle part of the target range during 1997. We would also draw your attention to the implications of the inflation “forecasts” in the *Economic Projections* published by the Bank last month: at that time, the Bank published a track for underlying inflation which was ‘uncomfortably close’ to the top of the target range throughout the balance of 1996. With the March quarter outcome being 0.1 percent higher than assumed in those projections, the year-to-date underlying inflation figures for the next three quarters will be closer to the top of the range than projected, and there must therefore be a risk of underlying inflation exceeding the top of the 0 to 2 percent range by a small extent in one or more of the next three quarters.”

Letter from the Governor of the Reserve Bank, Dr Don Brash to the Minister of Finance

19 April 1996

“You have written to the non-executive Directors of the Reserve Bank seeking their assessment of my performance under the Policy Targets Agreement signed with your predecessor in December 1992. Media reports suggest that you would also appreciate an explanation from me as to why this ‘second breach’ of the inflation target range has occurred, and for this reason I felt it appropriate to write to you directly. Your letter to Sir Peter Elworthy raised three questions, and I will begin by giving you my own reaction to those questions, before concluding with some further comments.”

What factors led to the breach of the target range?

“As I have acknowledged publicly on several occasions in the past, the Bank misjudged, during 1994 and early 1995, the degree of monetary policy pressure required to restrain inflation in 1995 and 1996. Despite the fact that we were rather more pessimistic about the inflation outlook than other official advisors (and certainly than most, though not all, private sector commentators), we were in retrospect too optimistic about the non-inflationary growth potential of the New Zealand economy. As a consequence, underlying inflation has been uncomfortably close to the top of the 0 to 2 percent target range since the second quarter of 1995. This has meant that even quite trivial price ‘shocks’ have been sufficient to push underlying inflation above 2 percent. This is well-illustrated in the latest quarter: had it not been for the increase in excise tax on loose-leaf tobacco by some 38 percent during the quarter, underlying inflation would have been almost 0.1 percent lower than was in fact the case, and the ‘breach’ would not have occurred. To reduce the risk of such individually-small events pushing underlying

inflation outside the range, it is important that we continue to aim to have inflation closer to the middle part of the range.”

“It is also perhaps worth noting that, over the 12 months to March 1996, some 54 percent of underlying inflation has been on account of the housing-related components in the CPI, with another 11 percent of the total being on account of government charges (principally tertiary fees and tobacco excise). All other price changes over the year totalled only about 0.7 percent, below the middle of the target range. This is not to suggest, of course, that the increase in housing prices should be disregarded: housing constitutes an important part of the consumption ‘basket’ of all New Zealanders; housing prices are directly susceptible to monetary policy pressure (and are not ‘external shocks’ which should be disregarded in formulating policy); and rapid movements in housing prices can foreshadow the emergence of wider inflationary pressures. But forecasting the housing-related components of the index is peculiarly difficult, not least because housing prices tend, like other asset prices, to be quite volatile.”

What action is the Governor taking to direct inflation back to within the target range?

“I think it is important to recognise that no action which the Bank could take now would affect the inflation outcome for this present quarter. Whether there is to be a breach of the target range for the June quarter, therefore, is already decided. There is very limited scope to affect the outcome even for the September quarter at this stage, though I will come back to that point in a moment. The real issue is whether the Bank has tightened conditions sufficiently, over the last 12 months or so, to ensure that you can be reasonably confident that underlying inflation will move decisively below 2 percent during 1997, or whether further tightening is required at this stage.”

“As you will recall, our *Economic Projections*, published four weeks ago, projected underlying inflation to remain ‘uncomfortably close’ to the top of the target range through 1996, with a significant risk that inflation would actually turn out to be somewhat higher than projected. Nevertheless, those projections also showed underlying inflation falling well into the middle part of the target range during 1997, and at this stage we have no reason to change that assessment. It is perhaps worth noting that monetary conditions have firmed somewhat from those assumed in *Economic Projections* as the market has reacted to the somewhat stronger inflationary pressures recently seen. Several private sector commentators are arguing publicly that the present configuration of monetary conditions is actually tighter than required to get underlying inflation comfortably back within the middle of the range during 1997.”

Are the current actions put in place by the Governor adequate to ensure a return to price stability?

“I have by implication made some comment on this point already. It is clear that, given the inflation outlook in *Economic Projections*, and the fact that underlying inflation has turned out to be 0.1 percent higher in the March quarter than we envisaged in that document, there is an appreciable risk that underlying inflation will exceed the top of the 0 to 2 percent range by a small extent in one or more of the next three quarters.”

“Does this suggest that, by the end of 1996, there may have been five ‘breaches’ of the target range? I myself disagree with that way of looking at the issue. We are now living

through the consequences of the Bank's failure to correctly assess the non-inflationary growth potential of the economy during 1994 and early 1995, as indicated above. That misjudgment is a matter for personal regret, as I have indicated on other occasions. But it is not 'five misjudgments', it is one. There have already been two 12-monthly outcomes where underlying inflation has been just above 2 percent, but the two intervening quarters also saw underlying inflation of 2 percent. What we have in prospect is a continuation of the consequences of that misjudgment in 1994 and early 1995. It is a matter for others to decide whether the performance of the Bank as an institution, and of me as its Governor, has been 'adequate', but I think it is important to see this as a single misjudgment, not a series of two (or potentially five) misjudgments."

"I have already mentioned that whether there will be a 'further breach' in the year to June has already been determined, at least insofar as the Bank can influence the outcome. Given the overall macroeconomic context, including the confidence created by the prospect of substantial tax reductions, the only prospect of reducing the chance of a further breach for the 12 months to September would be for the Bank to tighten policy aggressively now, with the specific objective of driving up the exchange rate strongly (perhaps by another 4 or 5 percent) - interest rate effects would simply not produce a reduction in inflation in time to influence the September quarter. In my own considered opinion, such action is both unnecessary and inappropriate - indeed, it would be totally irresponsible - given our present judgement that underlying inflation will return to the middle part of the target range by the middle of 1997. There would be a substantial risk that aggressive further tightening at this stage would have underlying inflation going through the bottom of the target range in 1997."

"Thus if you want an assurance that we will experience no further quarters where 12-monthly underlying inflation will exceed 2 percent, I have to say that I can not give you such an assurance for the present quarter or for September, and could only give you such an assurance for December if we were to instigate an immediate and substantial further tightening of conditions. Given our present assessment of the inflation outlook for 1997, I could not recommend this course of action."

"I think it is important that everybody recall the words of the non-executive Directors of the Bank in their letter to you last June, namely that it was their 'understanding that 0 to 2 percent was always intended to be a target towards which the Bank would be *constantly aiming*, not necessarily a target which could, given the inevitable uncertainties in forecasting and lags in the effectiveness of monetary policy, always be certain of attainment.' That is certainly my understanding of what the target means, but I think it would be helpful if the wider public began to understand that also. The sooner this reality is recognised by everybody the better it will be, I believe, for all concerned."

"In conclusion, may I assure you of my absolute commitment to continue operating monetary policy towards the goal of maintaining price stability."