5. MONETARY POLICY

Since 1970, inflation in New Zealand has averaged 12% per year.

Inflation imposes costs on the economy. It reduces our growth prospects and hurts vulnerable people.

As a small, open economy, New Zealand's economic performance depends upon its ability to respond to price changes in world markets. Stable and consistent policies allow us to adapt to changes in world markets more easily and at less risk to employment and growth.

This argues for a goal of price stability, with price increases between 0% and 2% per year as a good approximation of that stability.

Confidence that a consistent application of monetary policy will continue is essential to reduce high interest rates. The new Reserve Bank Act is an important reform. It requires the Government to be explicit about its objectives and the Reserve Bank to make every reasonable endeavour to meet those objectives.

Low inflation will be more easily achieved if the Reserve Bank has operating techniques and monetary indicators that are seen as consistent with achieving low inflation.

INTRODUCTION

Since 1970, New Zealand's inflation rate has averaged 12% per year, nearly double the OECD average. As a result, our price level is now nearly 10 times as high as in 1970. In contrast, through the 1950s and 1960s inflation in New Zealand averaged 4% per year. Only in the last two years has our inflation rate returned to lower single-digit levels in a way that can be sustained.

Monetary policy is the only effective policy instrument for restraining inflation over time. While other policies (especially those which enhance competition) also help keep prices down, they support monetary policy rather than replace it.

As a small and open economy, New Zealand is constantly exposed to significant and often unpredictable changes in world prices. These have a direct effect on the prices of our imported or exported commodities, but they also have the potential to affect a wider range of domestic prices.

The way we respond to commodity price changes is crucial. Our economic prospects would deteriorate if initial relative price changes were allowed to spread into general wage and price inflation. Stable and consistent economic policies would allow the necessary resource changes to occur at less risk to inflation, output, and employment.

This chapter discusses the role of monetary policy in assisting the process of economic adjustment and providing an environment conducive to economic growth. Particular emphasis is placed on the need for the Reserve Bank to develop operating techniques and monetary indicators that demonstrate the Bank has a consistent, medium-term focus directed at containing inflation pressures and reaching the goal of price stability. In this context, the chapter considers the role of various monetary indicators, including the exchange rate, interest rates, and growth rates in money and credit aggregates.

INFLATION OUTLOOK

In the year to September 1990, the Consumers Price Index increased by 5%. This increase did not include the full impact of the recent rises in oil prices or fully reflect increases in mortgage interest rates announced in August.

The largest individual contribution to inflation over the past year came from the housing component. This reflected strong growth in property prices, and also the effect of higher local authority rates. In addition to rate increases, increases in other public sector charges, such as student fees, and excise taxes on alcohol and tobacco also had a significant effect on the annual inflation rate. Public sector charges are estimated to have contributed around 1 percentage point of the overall 5% rise in the CPI. The contribution of public sector charges has been even greater over the last two years, as the July 1989 increase in GST temporarily increased the inflation rate by around 2 percentage points.

At the present time there is little upward pressure on inflation from profit margins. Unit labour costs are increasing only slowly as a result of wage moderation and the increase in productivity. The main influences driving inflation are the increases in public sector charges (including those of state-owned enterprises and local authorities) and increases in import prices which are currently running at around 5% per annum. Inflation in the private sector is probably running at an annual rate of 2% to 4%.

DOES INFLATION MATTER?

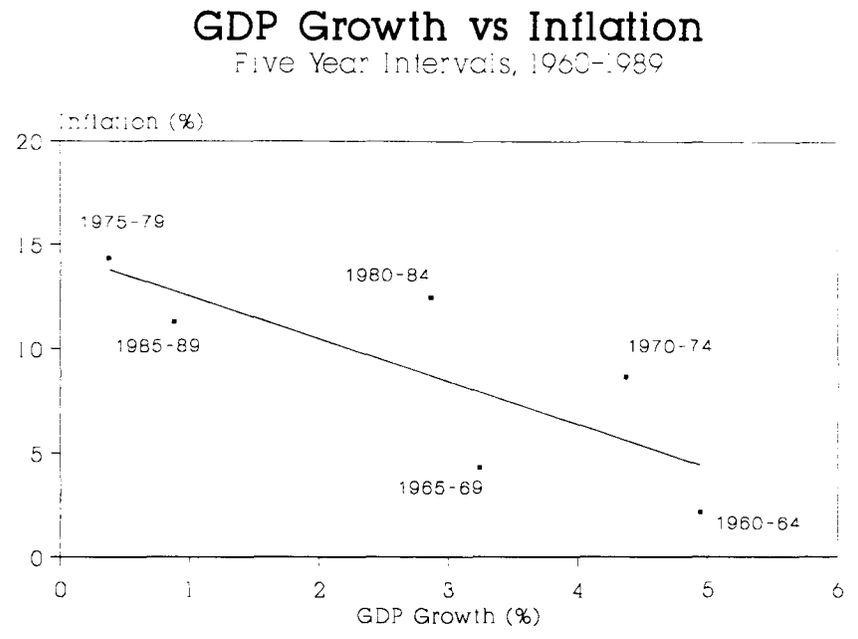
Inflation is a costly process. New Zealand's recent history of high inflation has almost certainly contributed to our poor overall economic performance. Inflation creates uncertainty and biases in the decision-making of households and firms. Information on prices that has been collected in the past quickly becomes obsolete and irrelevant as far as present decisions are concerned. It is unclear during inflationary times whether observed movements in wages and prices should signal changes in the allocation of resources - a key feature of market-based economies - or whether such changes are merely part of the general inflation.

The interaction of inflation with the tax system punishes savers and distorts patterns of business financing and investment. The full return on savings is subject to tax, even though part of this return should be viewed as compensating savers for the erosion in the real value (or purchasing power) of their savings due to inflation. For much the same reason, inflation creates a bias towards debt rather than equity financing of business activity, as the full nominal cost of borrowing can be deducted as a business expense. Investment decisions during inflationary times are influenced by businesses' desire to protect themselves against, and even gain from, the effects of inflation. For example, investment tends to be biased away from productive equipment and towards assets such as buildings and land which often generate high capital gains as a result of inflation, gains which may not be taxed.

Inflation also produces inéquities in the distribution of income and wealth. Inflation harms those who do not have the resources, the bargaining power, or the financial sophistication to protect their real income or wealth against the effects of inflation. Small savers, the elderly, and those on low incomes tend to be disproportionately represented amongst this group. For example, real (that is, inflation adjusted), after-tax interest rates available to small savers in New Zealand were negative in virtually every year from 1967 to 1988. In addition, inflation is the major risk faced in wage bargaining, where any real gains from low nominal settlements could be rapidly eroded away through higher inflation than expected.

There is no evidence, either from New Zealand or overseas, that high inflation can be relied on to support either stronger economic growth or lower unemployment. Indeed, the opposite is more often the case. Figure 5.1 shows the general deterioration in New Zealand's growth performance as inflation rose through the 1970s and 1980s. Figure 5.2 illustrates the increasing level of inflation from the mid-1960s to mid-1970s, albeit at a low level of unemployment, and then the deterioration in the level of unemployment from the mid-1970s to late-1980s with no sustained reduction in inflation until the last two years.

Figure 5.1



Source: Department of Statistics
and Treasury

Figure 5.2

Source: OECD Labour Force Statistics
and Department of Statistics

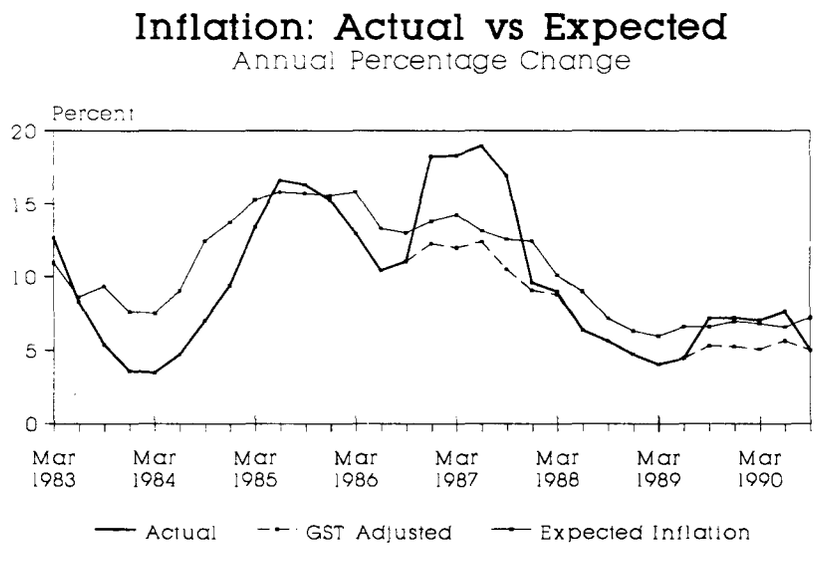
Low inflation, in itself, does not guarantee stronger economic growth. However, as part of a consistent, medium-term approach to policy formulation, a low inflation objective plays a key role in producing a more stable and predictable environment for economic decision-making. When these conditions are in place, stronger growth, along with generally more efficient and equitable economic outcomes, is more likely to occur.

ROLE OF MONETARY POLICY

Monetary policy is the only effective policy instrument for restraining inflation pressures over the medium term. Many influences, including changes in indirect taxes or changes in the prices of major commodities such as oil, can have a material impact on the overall price level. However, increases in such key prices are very unlikely to lead to an inflationary spiral unless they are supported and fuelled by further monetary expansion.

An "incomes" policy (including a wage-price freeze) may for a time lower the measured inflation rate. However, unless this policy approach is supported by restraint in other arms of policy, including monetary and fiscal policy, it is inevitable that inflationary pressures will build up and ultimately undermine the achievement of a low and stable inflation rate. As Figure 5.3 illustrates, even the wage-price freeze of 1982-84, which produced a sharp fall in the measured rate of inflation, did not reduce inflation expectations to nearly the same extent. When the freeze was lifted, there was a rapid resurgence of pent-up wage and price pressures. An incomes policy also tends to limit the scope for the adjustments in relative wages and prices that are needed to encourage resources to switch into more productive uses, and to signal shortages and surpluses of skills.

Figure 5.3



Source: Department of Statistics, National Bank and Treasury

Monetary policy restrains inflation by influencing the expansion of money and credit. This influence is transmitted largely through interest rates and the exchange rate. For example, a firmer monetary policy stance would generally increase short-term interest rates and the exchange rate, at least for a while. Higher interest rates and a higher exchange rate would act to slow demand, making it more difficult to pass higher costs, including wage increases, into prices.

Losses in real output and employment are likely to occur if prices and wages rise at a faster pace than is consistent with the monetary policy stance. Figure 5.3 illustrates that inflation expectations in New Zealand have generally lagged behind actual reductions in the inflation rate. Inflation expectations have also not fallen as far or as quickly as the monetary policy stance has intended. These patterns are consistent with the slow and at times negative rates of growth experienced here in recent years, although other factors, including structural adjustments in the economy, have also contributed to slow growth. Slowly-adjusting inflation expectations, and slow rates of growth, are also typical of the experiences of most other OECD countries that disinflated earlier in the 1980s. However, output growth in these other economies picked up once inflation had been brought down.

Inflation expectations, and the costs of disinflation, can be related to the strength of formal or informal "indexation linkages" in the economy. For many years the regulations and protections that characterised the New Zealand economy meant that higher costs were automatically passed along in higher prices. They also meant that wage increases in one sector were soon reflected in similar wage increases elsewhere in the economy.

The liberalisation reforms of recent years have begun to break down some of these linkages, with a positive effect on New Zealand's international competitiveness. The deregulation of some industries, reduction in trade barriers, and generally greater competitive pressures in the economy now make it more difficult for a price shock affecting one part of the economy to lead to much wider inflation pressures. In this way, continuing reforms at a microeconomic and structural level would significantly assist the conduct of monetary policy, and thus help keep inflation under control.

Institutions and Operations of Monetary Policy

The credibility of the objectives and conduct of monetary policy plays a key role in the disinflation process. Credibility centres on the acceptance by private sector decision-makers that the Government will stick to a stated commitment to maintain a firm monetary policy and secure a low rate of inflation. It may take a considerable period of time for credibility to be earned, particularly if there has been a history of such commitments not being fulfilled.

Our economic performance would be enhanced if wage and price setting behaviour is forward-looking and based upon the expectation that the Government's inflation objectives will be achieved. Such attitudes would make it easier for the economy to adjust to events such as the recent oil price movements or changes in indirect taxes. It also would make the task of securing overall price stability much faster and less costly.

Increased certainty about the consistency of monetary policy would facilitate reductions in nominal interest rates. This would occur in part as a result of lower inflation expectations. There would also be a reduction in the risk premium that is built into interest rates as a result of uncertainty about the direction of monetary policy in general, and the exchange rate in particular.

Surveys of inflation expectations and private sector forecasts of the inflation rate indicate there is a considerable distance to go before wage- and price-setters fully take into account the target of 0% to 2% inflation by December 1992. For example, surveys of the business sector and of households show that expectations of inflation over the next year are currently around 7% to 9%. This is well above the level that would be viewed as consistent with the inflation target and this suggests there could be continued pressures on output and employment during the disinflation process.

Three factors would contribute to further improvements in the credibility of monetary policy in New Zealand:

- Reductions in the actual rate of inflation would reinforce the credibility of low inflation as a key policy objective. The public support for this objective would also increase through time as people experience the benefits of low inflation.

- A firm and sustainable stance of fiscal policy would support monetary policy in reaching its price stability objective.

- Microeconomic policies, including further regulatory reforms and trade liberalisation measures, would strengthen competitive pressures, help control cost structures, and hence contribute to the maintenance of a low-inflation economy.

The **transparency** and **consistency** of monetary policy are important in conditioning inflation expectations. Transparency requires any short-run actions by the Reserve Bank to be readily understood and to be seen as consistent with medium-term objectives. As new or unforeseen situations arise, the reactions of the Reserve Bank should be readily predictable. Consistency means that monetary policy will always focus on the medium-term inflation objective of the Government. This requires the Reserve Bank to develop operating techniques and monetary indicators that establish that its actions are consistent with this objective.

The specific policy target of 0% to 2% inflation can be interpreted in the context of building both policy transparency and consistency. This target implies that monetary policy should be seen to be constantly leaning against emerging inflation pressures. It signals that monetary policy should respond in a consistent and predictable manner when unexpected price changes hit the economy (such as the recent oil "shock"). In this way, wage- and price-setters will come to realise that any attempt to pass an initial relative price change through into more general movements in wages and prices will lead to adverse consequences for output and employment. They will learn from these experiences, and over time will adjust their behaviour in line with the reactions of the Reserve Bank. This is part of the process through which the credibility of the Reserve Bank's conduct of monetary policy is enhanced.

An inflation target also provides a benchmark for assessing the performance of monetary policy. In this regard, however, what is important is not simply the attainment of a particular inflation rate at a particular time, but a proven track record of containing inflation pressures and maintaining generally stable prices on average over time.

Specification of the Inflation Target

The most commonly used measure of the general price level (and hence inflation) in New Zealand is the Consumers Price Index (CPI). However, the CPI does not fully reflect, or picks up only with a lag, effects like changes in the quality of goods and changing spending patterns. "Price stability" may be consistent with a small increase in the CPI. For this reason, the target of 0% to 2% inflation by December 1992, as specified in the Reserve Bank Governor's contract, is viewed as consistent with the price stability objective set out in the Reserve Bank Act.

The connections between monetary policy and inflation are indirect. There are long and variable lags between the adoption of a particular policy stance and its effect on the observed inflation rate. There is considerable uncertainty, therefore, as to how quickly current inflation pressures will abate, and about the particular inflation outcome the current policy stance will deliver.

Focusing an assessment of monetary policy on the achievement of 0% to 2% inflation by a specific date implies a degree of accuracy or precision in the conduct of monetary policy which is not present. The factors that influence the CPI in any particular period are not usually within the short-term control of the Reserve Bank. Placing primary emphasis on just one inflation outturn can divert attention from the more fundamental objective of conducting policy in a sustainable, consistent and transparent manner that delivers low and stable inflation.

In this context, a change in the inflation target (for example, a target of inflation below our trading partners' average, a wider band, or a delay in the target to 1993 or beyond) may not provide any scope for an easing of the present monetary policy stance. Indeed, several factors suggest that the policy stance should not change. These include the current level of inflation expectations which, at around 7% to 9%, is well above the inflation target, and the high risk premium incorporated in interest rates.

The last-mentioned factor suggests continued concerns in financial markets about the Government's resolve to maintain a firm monetary stance, and about macroeconomic policy direction more generally. In particular, there is considerable market concern about the fiscal outlook. Validating these concerns through an easing (or a perceived easing) of monetary policy would only compound the difficulties of building policy credibility. Signals of an easier policy stance could lead to a substantial fall in the exchange rate. The monetary response required to contain this fall could well result in interest rates ending up at a higher level than they were before the policy change occurred.

Further out, the policy stance required to hold inflation down to 2% or less need be no firmer than the stance required to hold inflation around a higher target (such as 4%). This depends largely on the credibility of the policy stance and, in particular, whether wage- and price-setters incorporate the lower target in their decision-making

behaviour. The experiences of countries like Japan and Germany, which have successfully brought inflation below 2%, demonstrate that this inflation outcome can be fully compatible with low interest rates, and strong output and employment growth.

There would be several risks associated with raising the inflation target or targeting a wider band (such as 0% to 4%), particularly if the upper end of such a band was seen as the actual objective. One difficulty is that such a change could be viewed as signalling an easing of monetary policy, with consequent risks for interest rates and the exchange rate. Another concern is that the volatility of the inflation rate tends to increase as the rate of inflation rises. As a result, there may be less danger of slippage back to inflation levels closer to 10% if the lower target (0% to 2%) is the objective of policy rather than a higher one. Such slippage has occurred in the United Kingdom, where inflation in retail prices was in the range of 3% to 5% from 1986 to 1988, but is now over 10%. In addition, even if inflation was maintained at a level of around 4%, the price level would double in less than 20 years. There will almost certainly be additional efficiency and equity gains associated with the lower target range, even though the sort of gains discussed at the beginning of this chapter may be harder to observe than those arising from initial reductions in inflation from double-digit levels.

CURRENT CONDUCT OF MONETARY POLICY

In the day-to-day operational aspects of monetary policy, the Reserve Bank currently is able to signal its view of monetary conditions through relatively minor changes in its routine operations intended to smooth the amount of cash in the banking system. However, there has on several occasions been considerable confusion about the purpose or intended strength of the Bank's signals, or their implication for the medium-term stance of policy.

The Reserve Bank's six-monthly Monetary Policy Statement represents a significant step forward in the way the Bank conveys its views and intentions regarding the conduct of monetary policy. We believe it is important for the Reserve Bank to continue improving the means by which it signals that its day-to-day operations are linked with a medium-term path of monetary indicators that is consistent with the price stability objective. We discuss below some of the advantages and disadvantages associated with current, and alternative, monetary indicators.

Monetary Indicators

The overall monetary policy stance is currently assessed against a range (or "checklist") of indicators. These include the nominal exchange rate, the level and term structure of interest rates, the growth rates in money and credit aggregates, and indicators of current conditions in the economy. Over the last two years, the main monetary indicator has been the exchange rate Trade-Weighted Index (TWI). There has been a strong perception in financial markets that the Bank has a "soft" (that is, unannounced and flexible) target zone for the TWI.

The Exchange Rate

There are arguments for and against the current approach of giving greater weight to the exchange rate in assessing and signalling the stance of monetary policy. The exchange rate can provide a "nominal anchor" for monetary policy. This is a benchmark which the market can use to assess monetary conditions and consider whether these are consistent with the Reserve Bank's medium-term objectives.

In addition, the exchange rate has a direct effect on the prices of imported goods and services, and hence on inflation pressures more generally. Around 30% of total domestic expenditure currently consists of imports. It is estimated that between 1985 and 1989, around half of the overall fall in New Zealand's inflation rate was accounted for by the appreciation of the nominal exchange rate.

On the other hand, the exchange rate plays a key role in the economy, in determining the relative price between goods that are exposed to external competition, and those that are not. As with other relative price movements, there is a strong case that the exchange rate should generally be allowed to move in response to changing assessments of the economy's performance and outlook, particularly changes that have a direct link with the external sector of the economy. These could include changes in the terms of trade, changed perceptions about the current account position, or changes in the underlying competitive position of the economy (other than those induced by domestic inflation).

A target zone for the exchange rate can significantly delay the time before adjustments occur in response to substantial changes in the economy's external balance or competitiveness. The adjustment pressures would instead tend to be borne by interest rates in the first instance, and then in prices, wages and/or output. Even if an exchange rate target were to be adjusted periodically by the Reserve Bank in response to changing economic conditions, the Bank would require considerable ability to disentangle real from inflationary influences on the exchange rate, to determine the degree and pace of adjustment in the target, and to signal its intentions clearly to financial markets. There is considerable potential for uncertainty and confusion in all these areas.

The major reason for floating the exchange rate in 1985 was to remove the difficulties associated with administrative determinations regarding both the level, and the time of adjustment, of the exchange rate. These difficulties resulted in taxpayers bearing the costs of speculative pressures which resulted in a devaluation of the exchange rate. Under a floating rate, the risks arising from exchange rate adjustments are borne by financial markets, where the relevant expertise and financial instruments for managing such risks are readily available. In addition, it is difficult for administrators at any time, but particularly during periods of comprehensive structural change in the economy, to determine what is the "correct" value of the exchange rate. The float removes the need for them to make such decisions.

A credible, non-accommodating stance of monetary policy is required if nominal exchange rate changes are to have sustained effects on real economic behaviour and competitiveness. Over the last 25 years in New Zealand, there is a consistent pattern of sizeable exchange rate falls being followed within two or three years by higher inflation. This occurred, for example, following devaluations in 1967, 1975 and 1984. Inflation reduced, and eventually eliminated, any real gains arising from the initial exchange-rate adjustment.

There is some evidence that the "flow-on" effects to domestic inflation of the August 1988 exchange-rate depreciation were more successfully contained than in past depreciations. Over this period, however, there were significant increases in labour productivity. Furthermore, increases in the terms of trade during 1989 offset to some extent the real income losses arising from the depreciation. Given these circumstances, there is no assurance that a sustained improvement in competitiveness (or lowering of the "real" exchange rate) would occur if a further nominal exchange rate depreciation occurred. The likelihood of competitive improvements being sustained would, however, increase if the Reserve Bank continues to build up a reputation for policy consistency and credibility. Microeconomic reforms which increase competitive pressures in the economy will help to break down indexation linkages and reduce inflation pressures.

The "Hard Currency" Option

A longer-term possibility for New Zealand could be to target the exchange rate at a constant level (or within a set band) against a low-inflation country. For example, countries in the Exchange Rate Mechanism (ERM) of the European Monetary System have successfully lowered their inflation rates by targeting a currency basket dominated by the Deutschemark. If, as in the ERM, the targeted country is also a major trading partner, domestic producers will tend to suffer from a deteriorating competitive position as long as domestic inflation continues at a higher rate than in the target. Under these arrangements, wage and price movements in each part of the economy need to take into account the competitive position of that business or industry, and may need to be guided by wage, price, and productivity developments in the targeted country.

Targeting a "hard" (or low-inflation) currency would provide more consistency than exists at present between the day-to-day conduct of policy and medium-term policy objectives. Credibility in monetary policy should in time be enhanced as a result of the linkage established between domestic policy and that of another country which has a proven track record in achieving low inflation.

Greater policy credibility, along with lower interest rates, would not follow automatically, however. The Reserve Bank (and the Government) would need to demonstrate its resolve to keep to the target exchange rate even if real costs emerge, in the form of output and employment losses. Such costs would be likely if this policy approach did not influence inflation expectations, or wage- and price-setting behaviour.

Under this approach the exchange rate would again be limited in its ability to adjust to real changes in the economy (which have not also affected the targeted country), unless a discrete change were made in the target band. Similarly, our economy would be exposed to the effects of real changes in the targeted country. In many respects, the hard-currency option is just one step away from a full currency union with the targeted country, and brings with it many of the advantages and disadvantages that currency union entails.

Interest Rates

Prior to its current emphasis on the exchange rate, the Reserve Bank focused on the yield gap (that is, the gap between the interest rates on 90-day bank bills and 5-year government bonds) in its conduct of monetary policy. This focus changed during 1988 as a result of the variety of factors, both "real" and "monetary", affecting the yield gap. This made it difficult for the Reserve Bank to infer the degree of disinflationary pressure in the economy by observing this interest rate differential.

If monetary policy focuses on a single interest rate (for example, the 90-day bill rate), there is a danger of an inflationary bias being imparted to policy. This occurs because under these arrangements there is a natural tendency for monetary policy to counteract, at least in the short run, an upward movement in the targeted interest rate by assuming a more expansionary stance. It may, however, be the case that the interest rate increase is itself an indication of growing concerns about inflation, and the monetary expansion will fuel these concerns.

Money and Credit Aggregates

A number of countries, including all but one of the seven major OECD nations, currently announce expected or targeted growth rates in one or more of the money aggregates. The extent to which these indicative growth rates actually determine the stance of monetary policy differs considerably across countries; in most cases, other influences (such as the exchange rate) also affect policy settings.

For a money or credit aggregate to be an effective indicator or target for monetary policy, this measure must have a reasonably close and stable relationship with nominal activity and hence inflation. In New Zealand in recent years, various developments have affected measured monetary growth. These include effects associated with the deregulation of the financial sector, and technological developments (such as cash-dispensing machines and the EFT-POS network) which have affected the public's demand for different forms of money.

As the pace of adjustment in financial markets slows down, there could well be increasing scope for the more prominent use of a monetary aggregate as an indicator or even target of monetary policy. For example, some evidence is emerging of a reasonably close relationship between the long-run growth rates in the broad money aggregate (M3) and in nominal GDP. Alternatively, the reasonably direct and close control the Reserve Bank can exercise over the monetary base (that is, the Bank's own liabilities, primarily in the form of currency and settlement funds) could in time make this aggregate a useful indicator for monetary policy. This approach would avoid some of the problems associated with targeting the exchange rate (although not without giving rise to some other difficulties, such as identifying "real" changes in the public's desired holdings of money).

It may be useful, at least as an interim measure, for the Reserve Bank to indicate its expectations regarding the growth rates in one or more of the money and credit aggregates, or to suggest the growth rates that (other things being equal) would provide some cause for policy concern.

Nominal GDP

Targeting nominal GDP would require that the monetary authorities form a view on the prospective real growth rate in the economy, and on the intended inflation rate. For example, the Reserve Bank could signal it would accommodate a 5% growth rate in nominal GDP, based on expectations of 2% real growth and 3% inflation. This signal would imply that faster than expected progress against inflation should lead to easier monetary conditions.

A nominal GDP target does require the monetary authorities to recognise real influences which may move the economy from its projected growth path, and to distinguish these from inflationary influences. In addition, there is a significant delay before reliable information on nominal GDP becomes available. A policy response based on this information would therefore lag behind actual economic developments, and might be inappropriate for current economic conditions.

CONCLUSION

We strongly support the continued emphasis of monetary policy on the medium-term goal of price stability. Attaining this objective would help households and firms make better-quality decisions, contribute to New Zealand's growth prospects, and yield more equitable economic outcomes.

In pursuing the objective of price stability, it is important for monetary policy to be seen to be maintaining a consistent focus directed at containing inflation pressures. Setting a specific inflation target can be helpful in this regard. Wage- and price-setters should come to realise that pricing decisions which are incompatible with the inflation goal will not be accommodated by the Reserve Bank, but are instead likely to lead to output and employment costs.

Institutional arrangements can be particularly important in establishing long-term credibility. Our past experience revealed biases in monetary policy and its implementation that were reflected in high and variable rates of inflation. The Reserve Bank Act represents an important institutional reform that places responsibility on the Government to be explicit about its monetary policy objectives. It places an obligation on the Governor to make every reasonable endeavour to meet those objectives and advise Parliament on how the Reserve Bank intends to conduct monetary policy to reach the policy targets that have been set.

The monetary instruments and indicators used by the Reserve Bank need to be those that help build policy transparency and consistency. The tools used to deliver a particular policy stance should enable the Bank to signal its view of current monetary conditions and to show that, if a change in the policy stance is required, this change is consistent with the goal of price stability. As a result, the Bank's day-to-day actions should reinforce the medium-term focus of policy.

In assessing the present conduct of monetary policy, we believe that less weight should be placed on the exchange rate. This would require the Bank to move towards placing relatively greater emphasis on other indicators, including the structure of interest rates and growth rates in money and credit aggregates. These alternative measures

would not remove the exchange rate from the Bank's checklist of indicators - the exchange rate would remain an important indicator of monetary conditions. However, if the Bank is seen by financial markets to be focusing less attention on the exchange rate alone, there may be more scope than appears to exist at present for the exchange rate to adjust in response to changing real economic circumstances that reflect the economy's external performance.