

Monetary policy in interesting times

An address by Donald T Brash, Governor of the Reserve Bank of New Zealand, to the managers of small- and medium-sized businesses in Whangarei on 21 November 2001

Ladies and Gentlemen

About seven or eight years ago, I was visited by a share-broker who told me what a great job the Reserve Bank had done in explaining its actions to the banks and the big corporates. I felt good, until he said "But frankly, you have done a lousy job communicating with the small and middle-sized businesses in New Zealand." True, I protested, but I can't even get a good mailing list to cover the tens of thousands of smaller businesses. "Fair enough", he replied, "but every small business has a bank account. Put it on the banks to invite their small business clients to meetings which you host, and to which you speak."

And from that conversation grew the idea of this meeting. We had meetings of this kind for the first time in 1995. We repeated the idea again in 1998. And now we are doing it for the third time this year.

In part, we want to use this meeting to tell you how we see the world. And in part, we want to learn, from your questions and comments when I have finished, how you see the world. We are acutely aware that the health and vitality of the New Zealand economy depends to a huge degree on the health and vitality of the small and middle-sized businesses represented in this room.

We live in "interesting times"

You will recall the ancient Chinese curse "May you live in interesting times". Sadly, these are "interesting times" and we all know why. Just one week after the terrible events of 11 September, the Reserve Bank made an unscheduled and largely unexpected interest rate cut, from 5.75 per cent to 5.25 per cent. Within the Reserve Bank, we briefly debated whether I should hold a press conference to explain what we had done. We decided not to, in large part because there would have been very little I could usefully have said. Essentially, what I could have said at that time was "We don't know yet what the economic consequences of these

events will be, and we certainly don't know what they mean for inflation in New Zealand. All we can say is that confidence has taken a huge knock; this is more likely to reduce prices than to increase them; and under these circumstances there is scope for lower interest rates." That would not have made for a very productive press conference.

Time has moved on, and there is more we can say now. Last week, we issued our latest assessment of the outlook for the economy and for inflation, and reduced the Official Cash Rate by a further 50 basis points to 4.75 per cent.

Why did we do that? Interestingly, when we looked over our shoulder at the historical data available to us, it was hard to see a justification for any cut in interest rates. The latest comprehensive information we had on economic growth showed that, in the first half of this year, the economy grew by 2.3 per cent, equivalent to an annual growth rate of more than 4 per cent. The latest information we had also showed that unemployment was at its lowest level in 13 years. Job advertisements, as surveyed by the ANZ Bank, were running at a high level. Many businesses were reporting that they had little unused capacity to meet increased demand. In some parts of the country, there were reports of great difficulty finding skilled and even unskilled staff. The world prices for many of our commodity exports, while lower than a few months earlier, were holding up surprisingly well. And to top it all off the exchange rate was not far above its all-time record low, which meant that, in New Zealand dollar terms, our exporters and tourist operators were being substantially insulated from the slow-down in the world economy.

To some extent, this was the same picture that we had painted in our August *Monetary Policy Statement*. There we had suggested that there might have been a case for an early *increase* in the Official Cash Rate were it not for the threatening clouds in the international economy. And that was weeks before we knew just how strongly the economy had grown during the first half of the year.

But three months on, and notwithstanding the relatively robust *historical* data, we have cut the Official Cash Rate by a total of 1 per cent. We have done that because, despite the relatively strong position that the New Zealand economy is now in, we see the real prospect of the economy slowing down quite significantly over the next year or so. And if that slow-down occurs, interest rates can be lower than previously without jeopardising the price stability objective which the Reserve Bank is required to achieve.

The basic cause of this rather abrupt change in the outlook for our own economy relates to a fairly substantial change in the outlook for the world economy. Back in early August, as our previous *Statement* went to press, the *Consensus* forecasts for the 14 countries which dominate our export trading suggested relatively slow growth this year but quite a marked pick-up in growth next year (figure 1). As we went to press with last week's assessment, the general expectation was for growth to be significantly slower this year than previously expected, and growth next year to be even more markedly lower than previously expected (figure 2). And this deterioration in the world outlook seems to get somewhat worse with every passing week.

Moreover, the deterioration is not confined to a single country. Most economists are now expecting a recession in the United States. Almost all economists are expecting a recession in Japan. Several of our biggest trading partners in Asia are clearly in recession already. Europe continues to slow down. Only Australia, among our main trading partners, seems to be enjoying reasonably robust growth for the moment. (Figure 3)

And this slowdown in the world economy is bound to have an impact on the New Zealand economy, in particular by reducing the demand for our exports and reducing the prices of those exports. We are beginning to see that already, and as it occurs we expect to see both some reduction in growth in New Zealand and some downwards pressure on prices – including some reversal of the very strong increase in the price of things like meat and dairy products, which in recent months has done so much to push up the price of the average food-basket. So it seems reasonable to believe that inflation will be much less of a problem as we look forward 12 months than it has been over the last 12 months.

Having explained our decision to reduce the Official Cash Rate last week, let me use this situation to make four points.

Price stability means neither inflation nor deflation

The first point I want to make is that the Reserve Bank is just as serious about keeping inflation above zero as it is about keeping it below 3 per cent. Dropping interest rates now is about preventing inflation falling too low. And if inflation threatened to go negative, you can be sure we would be very active indeed in stimulating the economy.

It's been said that any fool can keep inflation down, and that's true, but our task is much more demanding than that. I know our rhetoric is mostly about the economic and social costs of inflation, rather than about the economic and social costs of deflation. That's because, at least in New Zealand, inflation has been much the more common problem, certainly for the last 60 years. Also, because New Zealand went through a period of quite high inflation in the seventies and eighties, we have had to work hard to persuade people that we are serious about keeping inflation down, in order to bring down inflationary expectations.

But make no mistake. Inflation going below zero would be just as much a breach of the Reserve Bank's inflation target as having it go above 3 per cent. Deflation causes its own set of economic problems and distortions, doing social and economic damage. And our policy deliberations are always, without exception, mindful of both risks. We are always trying to find the policy setting – the interest rate – which will deliver an inflation outcome which is neither too hot nor too cold.

Preventing deflation is also part of the law under which I operate. The Reserve Bank Act 1989 makes it clear that monetary policy must deliver "stability in the general level of prices". And the Policy Targets Agreement which I have with the Minister of Finance, a requirement of the Reserve Bank Act, defines "stability in the general level of prices" as inflation measured by the Consumers Price Index of between zero and 3 per cent. Deflation is not "stability in the general level of prices", any more than inflation is.

This means that, once price stability has been achieved, and as a very rough rule of thumb, the Reserve Bank's monetary policy will be seeking to restrain *inflationary* pressures by *raising* interest rates roughly half the time, and will be seeking to restrain *disinflationary* pressures by *lowering* interest rates roughly half the time – as we did in the second half of 1998 and as we have been doing through most of this year.

New Zealand goes into this world slowdown in a strong position

Secondly, although New Zealand will be affected by the world slowdown, we are not completely hostage to external events. It is important that we don't talk ourselves into a gloomy frame of mind just because the slowdown in the world economy could be substantial, and could last well into next year. When the world slowdown began, many sectors of the New Zealand economy were in rude good health economically, as I have mentioned – and I haven't even mentioned such other advantages as a strongly capitalised banking system and a government running fiscal surpluses. In other words, we *start* into the slowdown from a good position.

Yes, export prices look likely to fall, and indeed have already done so in a number of cases, but in US dollar terms they have, on average, been at relatively high levels for much of the last year or so (figure 4), and in New Zealand dollar terms they have been pushed up even further by the low level of the kiwi dollar (figures 5 and 6). This low exchange rate provides very useful insulation from the downturn in the world economy, by propping up returns to New Zealand exporters (and indeed returns to those competing with imports) despite weaker prices abroad.

There has been a sharp decline in net confidence in the business sector in recent months, as measured by both the National Bank Business Outlook survey and by the quarterly survey undertaken by the Institute of Economic Research (figure 7). And businesses have become less confident not only about the economy in general, but also about the outlook for their own businesses.

But at least as of late last month, more businesses continued to expect an improvement in their own business over the

year ahead than expected a deterioration. As you can see from the graph (figure 8), the National Bank survey for September, taken prior to the tragic events of 11 September, showed that only 6 per cent of businesses expected that their own business would deteriorate over the year ahead. By the October survey, that had increased to 16 per cent expecting a deterioration. In both surveys, roughly half of all respondents expected no change in their business over the period ahead. And despite the increased gloom, roughly twice as many businesses were expecting their business to improve as were expecting a deterioration, even in October.

Interestingly, surveys conducted in September by both the Employers and Manufacturers Association in Auckland, and the Canterbury Manufacturers Association in Christchurch, showed a remarkably upbeat mood in both cities. And both surveys were conducted after the events of 11 September. A survey conducted by Bancorp in late October found respondents (134 in all) more optimistic about general business conditions, and more confident about increasing investment expenditure, than a similar survey four months earlier. A more limited survey of the top 20 listed companies undertaken by the *New Zealand Business Times*, also in late October, found that, with only a single exception, corporates had not changed budget allocations or staff hiring intentions since 11 September – and the exception was “a company that is subject to a particular restructuring in its business.”¹

Moreover, if the slowdown in the global economy affects us more adversely than we currently expect, there is scope to stimulate additional demand without causing inflation to accelerate. Typically, monetary policy is these days the policy instrument of choice for providing temporary stimulus to the economy. We have now eased monetary policy by reducing the Official Cash Rate from 6.5 per cent early this year to 4.75 per cent currently. There is little doubt that that reduction will help to cushion the effects of the international slowdown. But if we need to reduce the Official Cash Rate further, there is clearly plenty of room to do so, and in that respect we are in a very much easier position than the one in which the Japanese central bank finds itself, with official interest rates already at zero, and with no further reductions possible.

¹ *New Zealand Business Times*, 2 November 2001.

So there is good reason for businesses in New Zealand to be more optimistic about the future than is the case in many of our trading partners: New Zealand starts from a situation of relatively strong growth, and there is ample scope for monetary policy to stimulate the economy if that should be needed, without jeopardising price stability.

But unfortunately policy is unable to provide complete protection

But thirdly, having said that, it is unfortunately quite impossible for policy-makers, whether in the government or in the Reserve Bank, to protect your business from all the effects of the global slowdown.

In part that is because policy – whether government fiscal policy or Reserve Bank monetary policy – works with what in the trade we call a long lag, or delay. In other words, the time between when the Reserve Bank changes the Official Cash Rate and when that change impacts your business will almost certainly be many weeks and probably many months. I have heard that some businesses believe that a change in the Official Cash Rate can have an almost instantaneous impact in the market, because of the effect which such a change can have on confidence. But that is surely the exception rather than the rule. In most situations, the lag or delay between a change in monetary policy and the impact of that change on the economy is typically more than a year.

To make life even more complicated, the lags are not only quite long but are also variable – they vary somewhat from situation to situation.

This means that, if we had to offset the effect of, say, a world economic slowdown on the New Zealand economy by easing monetary policy, we would need perfect ability to see the future for more than a year ahead, perfect understanding of precisely where the economy is now, and perfect understanding of how the economy works.

Well, we do our best, and I am fortunate to have some of the brightest economists in New Zealand on my staff, trying to discern the future. We study 6,000 data series. We look for relationships which look realistic in recent history. We

talk to businesses up and down the country – about 50 or 60 before each quarterly *Monetary Policy Statement*. We use some sophisticated economic models, but stir in very large amounts of judgement. We are constantly looking to update our assessment of the real economy outside the Reserve Bank's doors. We get a steady flow of data relevant to New Zealand from overseas economies. We believe we are as well-informed about the economy as any other organisation in New Zealand, and better informed than most.

But we can still get it wrong. Let me illustrate. One of the most reliable relationships in recent economic history is that the world prices of the commodities New Zealand exports tend to rise when the economies of our trading partners are buoyant, and tend to fall when the economies of our trading partners are subdued. That sounds pretty much what one might expect on the basis of common sense, and that is consistent with the data (figure 9).

So since at least the December 2000 *Monetary Policy Statement*, we have been expecting the prices of our commodity exports to decline (figure 10). And we projected the same thing to happen in March this year, even though in the intervening period prices had risen some more, despite a steady weakening in the world economy. And we projected prices to fall in our May *Statement*, even though they had risen some more, despite still more weakening in the world economy. And in our August *Statement*, we again projected world prices to fall, even though by August they had risen still further and the world economy was looking quite seedy! And in the *Statement* we issued last week, we still projected that the slowdown in the world economy would produce a fall in our export prices! Indeed, had we not expected our export prices to fall, the case for reducing the Official Cash Rate last week would have been non-existent. Should we have changed our expectation about export prices because over most of the last year the traditional relationship between export prices and the growth of our trading partners has broken down? Obviously we don't think so, but the example is a good illustration of the difficulty of forecasting the economy even in "normal" times.

And of course these are anything but normal times. No economic model, and no economic forecaster, could have foreseen the events of 11 September. By definition therefore, given the long and variable lags between a change in

monetary policy and the impact of that change on the real economy, and the inability of even the most experienced central bankers to foresee the future, we will sometimes fail to adjust policy sufficiently quickly to protect your business from a sharp downswing – or for that matter, from a sharp upswing (though that may well cause fewer complaints!).

There is another reason why monetary policy can not protect your business from all the adverse effects of world events. Even if we had super-human ability to see into the future, the reality is that world events have quite different effects on different industries and different regions. Monetary policy, with its single interest rate instrument, can only react to the balance of inflationary pressures in the economy as a whole, not to the pressures in individual industries. In other words, we can't have a high interest rate to restrain the very buoyant conditions in the dairy industry but a low interest rate to support the software export sector, which has been adversely affected by the sharp deceleration of spending on information technology in the United States. We can only have an interest rate which seems appropriate to the economy as a whole – and must accept that that interest rate will seem far too high for some parts of the economy and will be arguably too low for other parts.

We saw that situation rather clearly in the mid-nineties, when the building sector was experiencing quite strong *inflationary* pressures, but many export industries were experiencing quite strong *disinflationary* pressures. It would have been great to have been able to have a high interest rate applicable to the building sector but a low one applicable to export industries. But as long as we have a common currency throughout New Zealand, that is not an option.

So the Reserve Bank can help your business by trying hard to anticipate developments in the New Zealand economy, and can adjust monetary policy quickly if it looks likely that inflationary or deflationary pressures will emerge. But we can't provide complete protection, either for the economy as a whole or, even more clearly, for each industry and region.

Monetary policy doesn't determine the economy's long-run growth rate

Finally, it is important to be aware of what monetary policy can and can not do for the economy's long-run growth rate.

There is now virtually unanimous opinion among economists and policy-makers around the world that central banks can't engender faster economic growth by being more tolerant of inflation. On the contrary, there is a virtually unanimous view that the best thing that monetary policy can do for economic growth is to keep inflation low and stable.

It is a myth, though one clearly believed by some New Zealanders, that the United States economy has grown faster than the New Zealand economy over the last decade because the US central bank has a mandate to encourage growth and maintain price stability, whereas the New Zealand central bank has only a mandate to maintain price stability. The reality is that in both countries it is now fully recognised that the best thing which monetary policy can do to encourage growth is to keep inflation under control. In that respect, the Federal Reserve and the Reserve Bank of New Zealand think and operate in the same way.

This is not the place for a comprehensive discussion on the determinants of trend growth in output. Essentially, economic growth depends on growth in inputs of labour and capital, and advances in the productivity with which that labour and capital are employed. And most of the things which impact on those factors are quite unrelated to monetary policy. Some studies have suggested that high levels of taxation discourage growth through their effect on incentives to work, save and innovate. Others have pointed to the importance of protecting private property rights if growth is to be dynamic. Still others note the importance of human capital, and highlight the role of education as a determinant of economic growth. And of course there are many other relevant factors, such as the rules and regulations which may make undertaking new investments a slow and cumbersome process. Getting policies in all of these areas right is crucial if trend growth is to be increased, and none of them are policies susceptible to central bank influence.

Conclusion

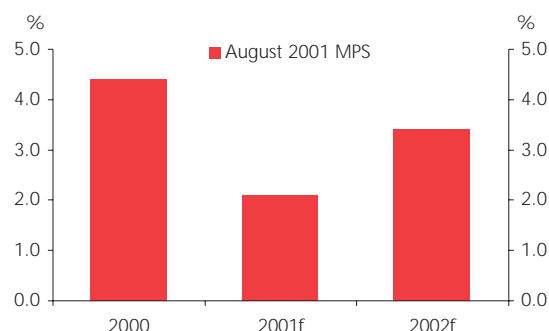
So in conclusion, in these "interesting times" –

- First, the Reserve Bank is as committed to avoiding deflation as to avoiding inflation, and that means that we will always be leaning against the wind to the best of our ability, tending to tighten policy if inflation looks likely to rise in the future, and tending to ease policy if inflation looks likely to fall below the bottom of our target.
- Second, the New Zealand economy is well-placed to weather the international slowdown, with moderate growth, low unemployment, an exchange rate which is providing useful support for export and import-competing industries, and ample scope for further easing of monetary policy if that should prove necessary.
- Third, even with the best will in the world, the best economists in the world, the most regular contact with companies up and down the land, monetary policy can never provide you with complete protection against the vagaries of life, whether these vagaries come in the form of international crises or in the form of some dramatic domestic development.
- And fourth, monetary policy doesn't determine the economy's long-term growth rate – that is determined by a whole range of factors which have nothing directly to do with the Reserve Bank.

Sometimes the Reserve Bank will need to leave monetary policy unchanged for months on end. Sometimes we will need to adjust interest rates in small incremental steps, as earlier in the year. And sometimes we will need to adjust rates more aggressively, as over the last couple of months. Different circumstances will require different responses.

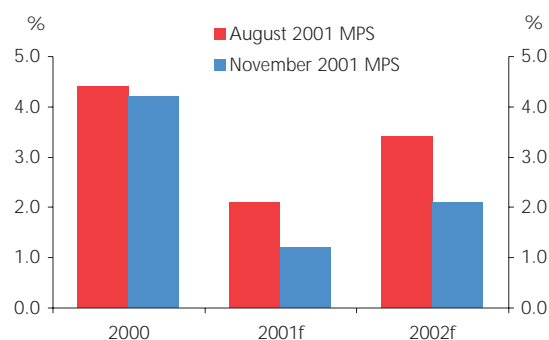
But what I can say is that, in "interesting times" as in normal times, the role of monetary policy is to help and not to hinder, and that is what we are committed to doing.

Figure 1
Export partner GDP growth - August 2001
Monetary Policy Statement
(annual average percentage change)



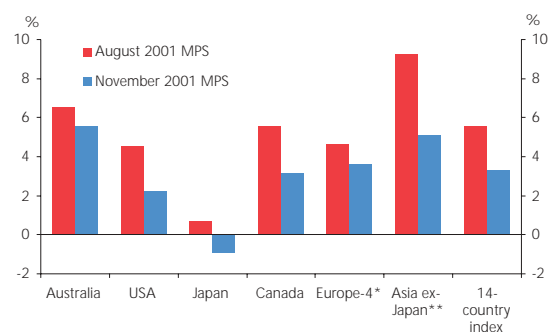
Source: RBNZ, Consensus.

Figure 2
Export partner GDP growth - November 2001
Monetary Policy Statement
(annual average percentage change)



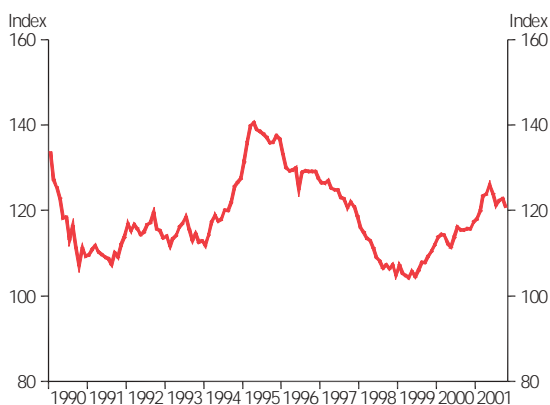
Source: RBNZ, Consensus.

Figure 3
Sum of 2001 and 2002 export partner GDP growth
(annual average percentage change)



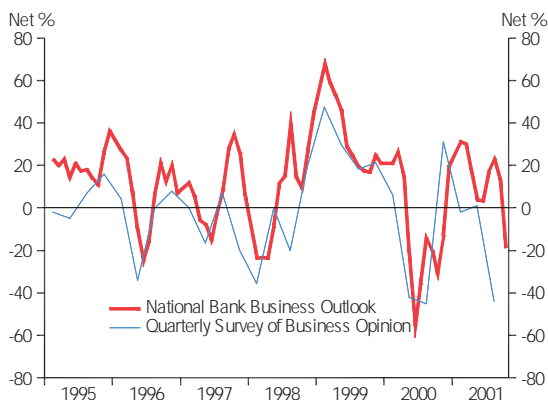
Source: RBNZ, Consensus.

Figure 4
Prices of New Zealand's export commodities
(denominated in US dollars)



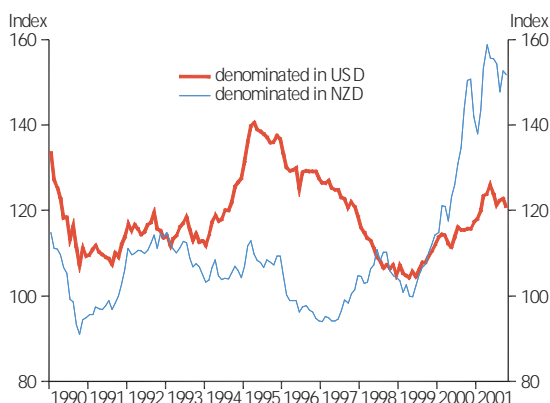
Source: ANZ.

Figure 7
New Zealand business confidence



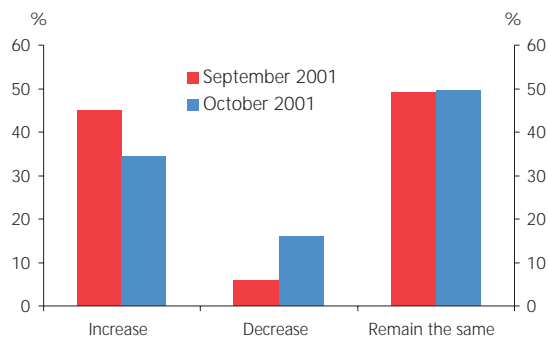
Sources: National Bank of NZ, NZ Institute of Economic Research.

Figure 5
Prices of New Zealand's export commodities
(denominated in US and NZ dollars)



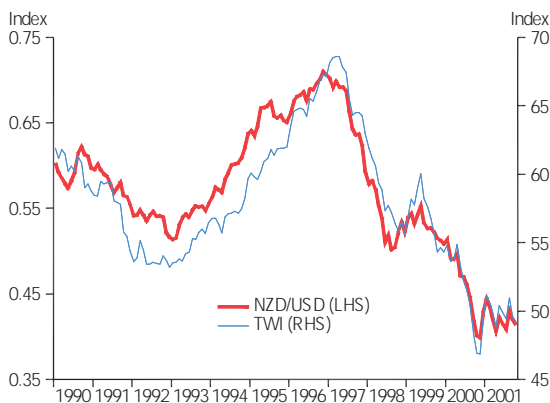
Source: ANZ.

Figure 8
Expected business activity
(September and October 2001 surveys)



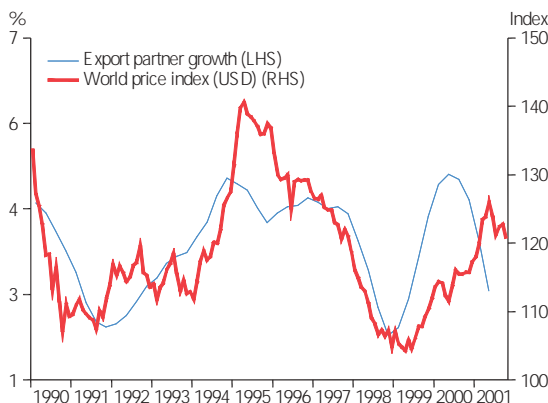
Source: National Bank Business Outlook.

Figure 6
NZD/USD exchange rate and the TWI



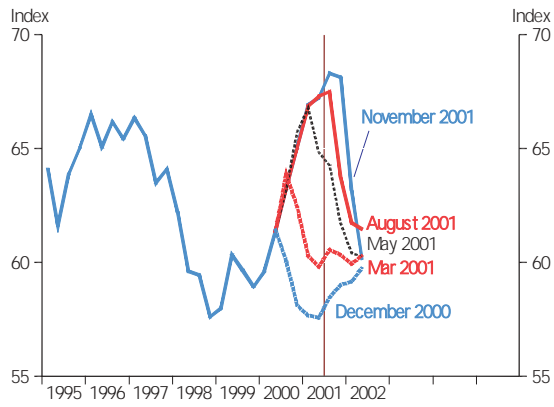
Source: RBNZ.

Figure 9
NZ's export partner growth and world commodity prices



Sources: RBNZ, Consensus, ANZ.

Figure 10
World export price index projections
(previous Monetary Policy Statements)



Source: RBNZ. November 2001 is central projection.