INFLATION AND THE MONETARY POLICY STRATEGY

In this article Michael Reddell looks at the future direction of monetary policy in the light of recent reductions in the rate of inflation.

Introduction

During the March quarter it had become apparent to a much wider audience that significant progress was being made in reducing inflation. Single digit CPI inflation for 1987 was announced in January and a broad range of commentaries and forecasts emerged during the quarter with predictions of inflation in the range of 4-7 per cent for the 1988/89 year.

However, accompanying the growing acceptance that much lower rates of inflation would be achieved, there was an expectation amongst some commentators that policy would be eased once inflation rates of around 5 per cent had been achieved or were in prospect. To counter these perceptions, the Minister of Finance and the Bank have sought to make clear the longer term inflation goal of price stability and to focus attention beyond the immediate horizon. By the time of writing, in mid-May, it was clear that the economy was on course for low single figure inflation over the next two years and that, given the current stance of monetary policy, price stability can be achieved in the early 1990s.

Inflation Performance

Recent data regarding inflation outcomes and prospects have been encouraging. These data afford some reason for confidence, after a year of little observable progress on inflation, that the disinflation process is now broadly on track.

The Producers Price Index increased by 1 per cent and by 1.1 per cent for inputs and outputs respectively in the December 1987 quarter, bringing the annual growth rates down to 7.1 per cent and 7.5 per cent. These annual rates of increase were the lowest since the September quarter of 1986, largely reflecting the continued strength of the exchange rate. The annual rate of increase in house building costs fell to 4 per cent by February, and evidence suggests that the rate of increase in existing house prices has also moderated since late 1987.

The increase in the Consumers Price Index (CPI) for the March quarter, although slightly higher than expected at 1.8 per cent, contributed to a fall in the annual inflation rate to 9 per cent for the year to March 1988. The inflation rate is nevertheless still high by most standards except those of recent New Zealand history. However, if the home ownership component is excluded, the annual rate of increase is only 7.6 per cent, and the annual rate of food price inflation, at 6.3 per cent to April, is even lower. Furthermore, on a quarterly basis our inflation rate, excluding home ownership, is now somewhat below that of Australia. Looking ahead it appears unlikely that the June quarter CPI will be as low as some of the most optimistic recent forecasts. However, even a quarterly increase of 1-1.5 per cent (after the 3.3 per cent increase last June) will result in a reduction in the annual inflation rate to around 7 per cent by June.

The reductions in inflation to date and those likely over the next few quarters are consistent with the Reserve Bank's latest econometric model forecasts, released in March, predicting CPI inflation of 5.5 per cent for the year to March 1989, falling further to 4.3 per cent by March 1990. Protection reforms announced since those forecasts were released, particularly those which led to an accelerated reduction in new car prices in early May, and possible reductions in petrol prices following deregulation, reinforce this relatively favourable outlook.

Recent surveys provide some encouraging evidence that the inflation expectations of small businesses and households, in particular, have fallen substantially in recent months. The Bank's May survey of business expectations recorded an expected CPI inflation rate of 6.6 per cent by March 1989, more than three percentage points down on the year ahead outlook of the September quarter survey, although still higher than official and most private inflation forecasts. The NZIER March Business Opinion Survey recorded a very significant reduction in the proportion of businesses expecting to raise their own prices over coming months. The National Bank's April survey of its small to medium business customers' expectations provides some additional cause for optimism, with an expected inflation rate for the year ahead of 9.2 per cent, down more than four percentage points from the October 1987 expectation. Furthermore, the Reserve Bank's April household survey, taken immediately following the announcement of the March quarter CPI, showed both a substantial reduction in expected inflation, to 8.4 per cent for the year ahead, and, for the first time, a significantly larger proportion of the population expecting inflation to fall over the coming year than expecting it to rise. This reduction in household expectations is particularly welcome in view of the considerable reduction in mortgage interest rates announced over recent months, and represents a significant closing in the gap between financial market expectations (which significantly influence interest rates in the short term) and surveyed household and small-business expectations.

Monetary Policy Strategy

There now appears to be broad acceptance that inflation is at last being brought under control and that marked reductions in the annual rate of inflation will be achieved over the next few quarters. However, many sections of society still appear to be making decisions which are inconsistent with a sustained fall in the inflation rate over the next few years to below 5-7 per cent. One manifestation of these continuing high expectations is the willingness of some agents to borrow money at rates of up to 17 per cent for three years.

In the second half of the March

quarter, there appeared to be a growing consensus that once inflation was reduced to somewhere around 5 per cent the Government and Reserve Bank would ease monetary policy, and shift the focus of policy elsewhere. Official concern at the growing credence given to this view, and the implications of its acceptance for pricing behaviour, particularly in the forthcoming wage round, prompted a more explicit statement of the ultimate inflation objective than had previously been formally made. Since 1985, the inflation objective over the succeeding few years has generally been discussed in terms of a non-specific range – 'low single figures' or 'at or below the levels of our trading partners'. This approach partly reflected the fact, given New Zealand's lamentable inflation record over the past 20 years, that even the achievement of these relatively non-specific objectives would represent a radical break with the past and a considerable improvement.

To dispel any possible doubts or misconceptions about the future direction of monetary policy and the ultimate inflation objective, the Minister of Finance has made various public statements since early April reiterating that he has no intention of easing monetary policy when inflation reaches 4-6 per cent, and that the ultimate goal is to achieve price stability by the early 1990s – consistent with the performances of many of our principal trading partners[1]. (Many major economies now have measured consumer or wholesale price inflation rates of below 2 per cent, and all of our principal Western trading partners except Australia now have CPI inflation rates of below 4 per cent.) The Bank shares the Minister's objective, and in a recent speech the Governor spoke of the historic opportunity now facing New Zealand to turn our backs on over 50 years of inflation, and go on to achieve price stability in the 1990s. Although price stability in itself will not generate an 'economic miracle', it is worth noting that many countries with low inflation rates (including the United Kingdom, the United States, Japan, Switzerland and West Germany) are now enjoying the longest period of sustained real economic growth experienced for several decades.

In New Zealand, inflation has generally encouraged speculative investment while discouraging financial savings and long-term productive investment, mainly as a result of the tax treatment of nominal interest receipts and payments. Distortions such as these and the uncertainty which inflation inevitably brings have hindered New Zealand's economic performance, and imposed costs which have inevitably been borne most heavily by the poorer and less fortunate sections of society. By eliminating the distortions and uncertainty generated by inflation, a further contribution will be made to improving New Zealand's output and employment performance, reinforcing the many other positive aspects of the Government's economic reform programme.

The costs and distortions attributable to inflation generally increase in magnitude as the rate and variability of inflation increases. However, there are also reasons to believe that the existence of any positive level of inflation results in additional costs compared with an environment of sustained price stability. First, if there is confidence that price stability, rather than simply a low positive rate of inflation, will be maintained, economic agents will be more ready to enter into longer term financial contracts. This greater willingness arises because the additional information-gathering or formal extra provisions necessary to take into account possible increases in the general price level will no longer be required. Secondly, international experience suggests that the maintenance of near price stability (such as in Japan, Switzerland and West Germany) creates its own inertia, minimising the risks of any future resurgence of inflation, by entrenching a social and political commitment to a stable price level. A commitment to a stable price level is likely to be seen as considerably more socially and politically credible over the longer term, than a stated commitment to maintain a stable rate of inflation (say 5 per cent). Although future rates of inflation are inherently uncertain, a firm and credible commitment to price stability should help reduce the degree of uncertainty facing economic agents in their planning. For reasons such as these, the Minister of Finance has stated that he is determined not to settle for the partial achievement of attaining inflation rates of around 5 per cent, but will continue the disinflation process to achieve price stability.

However, to adopt an objective of price stability is one thing; to achieve it, in the face of high degrees of trade protection and major rigidities in the labour and some product markets, is another. If necessary, monetary policy can by itself achieve price stability in the medium term and it will continue to be aimed at that end. However, monetary policy by itself is a relatively blunt instrument, and if private and public sector decisions are not made consistent with the thrust of monetary policy, there can be significant employment and output costs. To minimise these costs and create a more favourable environment for the achievement of the inflation objectives, the Bank has repeatedly urged that the disinflationary monetary policy be more fully supported by further rapid and substantial reductions in the Government's financial deficit (including the possibility of running a financial surplus for several years), by accelerated reductions in trade protection, and by liberalisation in the labour market.

Cost pressures must abate quickly if the elimination of inflation as envisaged by the Minister is to be

[1] In terms of the CPI, this objective is likely to be consistent with a small positive measured inflation rate, in the order of 0-2 per cent, as a result of several problems in the construction of the index such as the difficulty of allowing for the impact of quality improvements which are captured in prices.

achieved without generating significant increases in unemployment and foregone output. A key to the success of the disinflationary strategy and the achievement of price stability will be to influence the wage rounds of the next two years. The 1987/88 wage round increases (predominantly between 7 and 8 per cent) were higher than those in the 1986/87 round and were too high to be consistent with the stance of monetary policy given the pressures which were already apparent on the productive sector. The costs of these excessive wage increases are being seen now in further factory closures and rapidly rising unemployment. It is imperative that the next two wage rounds be settled at lower levels, ideally at around the rate of increase in real productivity – the only sustainable basis for wage increases in a non-inflationary environment. Monetary policy has an important role to play in influencing such wage restraint. The Bank must ensure that a credibly non-accommodative stance is consistently maintained to influence expectations and wage claims. This policy stance will also mean that conditions remain sufficiently firm so that in the event that adequate wage restraint is not achieved, the excessive wage claims will be reflected not in higher prices but in lower profits, reduced output and further employment losses.

However, the success of monetary policy in restraining wage increases is at present inhibited by legislative restrictions on the operation of the labour market. The Bank's recent discussions with businesses confirm a considerable sense of frustration among many employers at their inability to negotiate wages directly with their own workers. Under the Labour Relations Act a firm whose employees are covered by a wider occupational or industry award cannot opt to negotiate wage rates for its workers which are lower than the rates specified in the award unless that firm can first persuade the union concerned to cite it out of the national award and negotiate separately. This inflexibility exists even if the firm would be forced to shed labour or perhaps close down entirely because it could not profitably maintain existing production given the award wage. Even if the firm's own workers wish to negotiate directly, they are unable to do so without the approval of the union, and in general the rule requiring unions to have a minimum of 1,000 members makes it impossible for the workers in hard-pressed firms to opt out of an unresponsive union and form their own.

Within this institutional environment, if industry or occupational awards are set at some average of employers' ability to pay, some firms, which are facing more difficult market conditions than average, will almost inevitably have to shed labour. Those workers in firms which can absorb or pass on high average wage increases will have benefited, and so they and their leaders have no direct incentives to moderate their wage claims. With unemployment already high, and with a continuing high degree of trade protection still sheltering many industries from competition, such a labour market system acts to magnify both the economic and social costs of disinflation.

However, the labour market is not the only area where change is desirable in order to reduce the costs of disinflation. It is apparent that the traded goods sector has experienced higher costs arising from the disinflationary process than have those sectors with a high degree of import protection. In particular, industries still covered by quota protection do not face the same exchange rate pressures as exporters do. Even though the cost of competing imports may fall as the exchange rate rises, a quota prevents domestic purchasers from switching from domestic production towards imports. For consumers, such trade protection means that the cost of a basket of consumption goods does not decline as it would in the absence of quota protection. In turn, wage demands are likely to be higher than in the absence of protection, and, if these claims are reflected in actual wage rates, employment opportunities will subsequently be affected, especially in the exposed sectors.

The exposed sectors (exporters, and import-substituting manufacturers in unprotected sectors) are also adversely affected by an exchange rate appreciation if they purchase inputs from quota-protected industries. The cost of inputs purchased from such industries will not fall in line with the reductions in the prices of their outputs (mainly exports) or of competing imported goods. The resulting loss of profitability is likely to lead to further reductions in employment in the traded goods sector. The impact of trade protection in exacerbating the costs of disinflation, combined with the more fundamental reasons – related to the inefficient allocation of productive resources induced by protection – have formed the basis for the Bank's call for a substantial lowering in import protection. The Government's recent decisions to remove import licensing on motor vehicles and to reduce tariffs on goods not subject to industry plans are recognised as moves in the right direction, but the Bank believes that further more far-reaching reforms remain desirable and appropriate, particularly to support the process of disinflation.

Some moves have been undertaken in the fiscal area which have helped to reduce the costs of disinflation, but further action would be appropriate. Government expenditure has continued to increase over the past three years. However, the revenue increases have been such that the financial deficit has fallen from 6.3 per cent of Gross Domestic Product (GDP) in 1984/85 to 2.2 per cent in 1987/88, easing the pressure the Government's financing requirement imposes on domestic interest rates. However, despite this progress the continuing need to fund a net government financial deficit continues to exacerbate the degree to which the burden of disinflation is being borne by the productive sector, already under considerable pressure from the impact of the necessarily tight monetary policy. In the Bank's view, the appropriate response would be further reductions in the Government's financial deficit, so that the fiscal position acts to ease, rather than to hinder, the transition to price stability, and helps spread the burden of adjustment.

Summary

While the inflation outlook has improved considerably since late 1987, the Minister of Finance and the Bank have recently reaffirmed their commitment to the achievement of price stability. With a continuation of the firm policy stance the steady reductions in the rate of inflation envisaged over the next two years can be extended to the achievement of 0-2 per cent annual CPI inflation by the early 1990s. Monetary policy will continue to be aimed at this end. However, further employment losses will be unavoidable unless the firm monetary policy stance is reflected in a further substantial fall in price and wage expectations. Further reductions in the fiscal deficit and in the degree of import protection, together with institutional reforms in the labour market, could contribute significantly to ensuring that domestic cost pressures abate more rapidly than has been apparent to date. Although the Bank is encouraged by the recent reductions in inflation expectations, expectations of price inflation and future wage increases are still much higher than is consistent with the stance of monetary policy. To reduce the likelihood that wage claims will remain unrealistically high, the Bank regards major changes to labour market policy as essential to minimise the employment and output costs associated with the achievement of the price stability objective.