1988 ANNUAL REPORT – GOVERNOR'S STATEMENT

The Reserve Bank's 1988 Annual Report was prefaced by a statement by the Bank's Governor, Sir Spencer Russell. The full text of this statement is reproduced here.

Monetary policy continues to be directed consistently towards reducing inflation and eventually achieving price stability. That it is succeeding in attaining this objective, is now clear from the substantial reductions that are occurring in the inflation rate. Consumer price inflation in the year to March 1988, at 9 per cent, reached its lowest level since September 1973 (excluding the period of the wage/price freeze) and the rate is widely predicted to fall further. Indeed the Bank is forecasting the annual inflation rate to be in the order of 4 per cent within the next two years.

Yet even 4 per cent inflation is high relative to the rates of some of our major trading partners, and the Bank believes it is necessary to retain a consistently firm monetary policy so that the reduction in inflation will not be stalled before the objective of price stability is achieved.

The process of disinflation has not been costless. The economy has entered a period of recession with an associated increase in unemployment. Real GDP growth for the year to December 1987 was just 0.9 per cent while real consumption and investment expenditures have been falling, especially since the share-market crash of October 1987. At the same time, the recession's impact in reducing imports has been a factor in the continued improvement in the current account of the balance of payments. The current account deficit in the year to March 1988, while still at an historically high level of 3.8 per cent of GDP represents a considerable reduction from the 8.4 per cent figure of 1984/85.

This improvement has also in part been due to a 12 per cent increase in the terms of trade and to relatively strong export volume growth – especially in the areas of horticulture and forestry. This export volume growth took place despite a 5.8 per cent appreciation in the Bank's trade-weighted nominal exchange rate index and despite an approximate 18 per cent appreciation in the (inflation adjusted) real exchange rate. Although export volumes are still increasing, much of the strength in the meat, hides and skins area over the past two years has been due to a run-down in stock numbers which, in turn, has reflected the downturn in profitability experienced generally in the tradeables sector.

A consequence of the difficulties faced in the tradeables sector, and of the recession in general, has been the increase in unemployment. The official Household Labour Force Survey measure shows the number of unemployed to have risen from 66,900 in March 1987 to 80,600 in March 1988 – an unemployment rate of 5 per cent of the labour force – while the number of registered unemployed increased by 30 per cent over the year to stand at 101,770 in March 1988.

This increase in unemployment, which was particularly marked in the March 1988 quarter, is indicative that the restructuring and disinflationary processes of the past four years are still not complete. On the restructuring side, the move to implement greater efficiencies within the private and state sectors has inevitably entailed some staff reductions. Such redundancies are not welcome in themselves, but they have been a necessary component in increasing the competitiveness of New Zealand production. They have also been necessary in order to reduce the costs of providing public sector services, so benefiting the purchasers of such services while also acting to reduce the fiscal deficit, and so reducing Government's borrowing requirements.

The Bank has argued consistently that a reduction in the fiscal deficit, or indeed the generation of a fiscal surplus, is required to complement the firm monetary policy stance. There is no doubt that in the process of reducing inflation, monetary policy has acted to increase real interest rates, at least in the short run. However, Government borrowing tends to put further pressure on domestic interest rates. It is to reduce this additional source of interest rate pressure that the Bank has called for reductions in the Government's financial deficit over and above the sizeable reductions already achieved. In inflation-adjusted terms, this process is likely to require the Government to run a financial surplus for a period which, in turn, would help Government achieve its aim of reducing its outstanding real indebtedness.

In addition to calling for moves on the broader fiscal front, the Bank has called consistently for further reductions in the level of import protection. Import quotas still exist for a number of industries covered by industry plans, while, on average, tariffs remain high compared with those in other developed countries. The effect of these protective barriers has been to delay the need, in the protected sectors, for similar adjustments in efficiency and competitiveness to those undergone in the exposed sectors. This delay has been an additional factor in reducing the competitiveness and profitability of exporters which use the protected sectors' goods as inputs.

While recognising that a reduction in protection will almost certainly involve redundancies in a number of currently protected industries, the Bank considers that the countervailing effects of increasing profitability and employment in the unprotected sectors must be given more weight. This is because the implied production switch is towards internationally competitive industries which are likely to have a long term future and away from industries which are uncompetitive and whose continued protection effectively constitutes a tax on the New Zealand public.

The Bank acknowledges that Government has moved to reduce protection levels, particularly with the announced moves to abolish import licensing for motor vehicles from January 1989, and to reduce duty on goods not subject to industry plans over the four years to July

1992, and endorses these measures. However, even after these moves are fully implemented, a number of industries will still have significant tariff protection, and the Bank considers that a strong case remains for further reductions in protection to be implemented.

Implementation of real fiscal surpluses and of reductions in border protection, together with the maintenance of the firm monetary policy stance, are all desirable elements of a co-ordinated economic strategy. By themselves, however, they are not enough to achieve the twin objectives of low unemployment and price stability. Without changes in labour market practices, unemployment is likely to remain high, especially while the major restructuring and disinflationary processes are continuing. The restructuring process inevitably means that a significant number of firms will be exposed to greater competition than before, with the result that profitability is likely to decline unless firms can reduce costs or increase productivity.

For other firms, restructuring will open up new profitable opportunities. The existing wage-fixing system has long had a bias towards retaining fixed relativities and is still underpinned by legislation that prevents individual employers from freely negotiating wages with their employees. It is not adequate to cope with the current changes in the commercial environment. A firm which faces increased competition because of a tariff reduction can increase its competitiveness either by limiting its wage rates and retaining existing production levels and staff (if such a scheme could be negotiated), or it can adopt economy-wide wage increases but increase productivity by shedding labour. If the firm's wage decision is constrained by the award system, the latter outcome is almost inevitable. The result is that the more impediments that are placed on free wage bargaining at the firm level the greater will be the unemployment and social costs of restructuring.

This is not to say that increased wage flexibility will overcome all unemployment potentially generated by restructuring – some temporary increase is unavoidable given the major changes required to overcome existing inefficiencies in both the public and private sectors. But given the social costs and inequities associated with unemployment, one cannot ignore the contribution that more flexible bargaining structures can make to alleviating the problem.

The same lesson applies to the need for wage flexibility in response to the process of disinflation. The Bank acknowledges that the firm monetary policy stance has led to an increase in real interest and exchange rates which has had the effect of reducing the profitability of the traded goods sector. While the disinflationary effects will be temporary, and will ease as the price stability objective is attained, they nevertheless may have a significant effect on employment if firms are unable to adjust wages to reflect the tighter conditions.

The results of the 1987/88 wage round make it clear that the required adjustment to wage rates has not yet taken place. The increases, most of which were in the order of 7 to 8 per cent, were out of line with the stance of monetary policy and meant that many firms have had no option but to shed labour.

The lesson that this has for future wage setting is clear. Firms and unions need to be forward looking in their negotiations, taking full account of the announced monetary policy stance and its implications for sustainable wage increases. If employment levels are to be maintained, this means that wages can only increase to the extent that productivity gains are achieved in individual enterprises. If such wage setting behaviour can be achieved, and complemented by further reforms on the fiscal and border protection fronts, then it will be possible to reduce the costs of adjustment while at the same time moving more rapidly towards the price stability objective.