1989 ANNUAL REPORT – GOVERNOR'S STATEMENT

The Reserve Bank's 1989 Annual Report was prefaced by a statement by the Bank's Governor, Dr Donald Brash. The text of this statement is reproduced here.

The 4 per cent inflation rate in the year to March 1989 – down from 9 per cent in the year to March 1988 – is testimony to the success of the Bank's disinflationary monetary policy pursued for the past four years. This inflation rate is the lowest recorded since 1969, excluding the 1982-84 price freeze period. At a time when inflation is rising overseas, it has brought New Zealand's inflation below the rates of three out of our four major trading partners. The remaining challenge now facing the Bank is to achieve and maintain price stability by the early 1990s. We define price stability as annual increases in consumer price inflation of 0-2 per cent.

The disinflation process has, unfortunately, contributed to the recent recession in economic activity and the rising unemployment. But while a lower level of activity has led directly to some employment reduction, wage and salary demands have, until recently, failed to come into line with lower inflation outcomes. Consequently real wages – as faced by employers – have risen and more jobs have been lost. However, settlements in the 1988/89 wage round have been more in line with the current inflation rate. This development may signal more flexible wage settlements in the future.

It is not true that monetary policy is responsible for the full extent of recent unemployment growth. Over the last two years restructuring of New Zealand industry rather than the disinflation process has been the major cause. It is important that this fact be understood because some claim that the way to solve the unemployment problem is to loosen monetary policy. At best, that would produce a small, temporary boost to employment. More likely would be a combination of rising inflation and high unemployment, known as stagflation, as experienced by most OECD countries in the 1970s.

It is also vital that employers and union officials do not mis-read the GST-induced increase in the consumer price index (CPI). This increase will not mean that the underlying downward trend in inflation has reversed. The Bank is determined that the downward trend in CPI inflation will be re-established following the GST impact. This objective means monetary policy will not accommodate any passing on of the GST increase into wage rises and second-round price increases.

On the basis of this non-accommodating policy, the Bank is currently forecasting unemployment[1] to peak in the September quarter at around 7.5 per cent of the labour force. Thereafter it will decline gradually as the economic recovery gets underway. There is no guarantee, however, that economic growth will by itself bring back the low levels of unemployment experienced in the past. Experience both within New Zealand and overseas suggests that change in the labour market itself will be necessary to bring about a big drop in unemployment.

More flexibility over work practices and wage rates at industry and plant levels would help employment growth, as would reductions in the real cost of labour – through growth in productivity, for example. Specific labour market reforms which should be considered include: abolition of the '1,000 member' rule; provision for individual employers, instead of just the unions, to be able to opt out of the national award structure and negotiate directly with their workers and unions; more effective skills training programmes; and a review of the unemployment benefit structure.

The current account deficit has improved over the course of the March year to 2 per cent of GDP, from 4 per cent in 1987/88. This improvement stems from continued export volume growth, a 6 per cent rise in the terms of trade, and reduced import demand. It also clearly reflects a higher level of saving by the household and corporate sectors following the sharemarket crash of October 1987.

The Government made a small contribution to the overall improvement in savings with the fiscal deficit falling from 2.2 per cent of GDP in 1987/88 to 1.8 per cent in 1988/89. Some large one-off influences underpinned this result. In order to consolidate the deficit reductions of recent years and to permit further reductions, the Government announced a range of tax increases and expenditure cuts in the Economic Statement of 21 March 1989.

While the Bank has no strong view about the socially desirable level of Government expenditure, the recent growth in overall expenditure gives cause for concern about the budget control process. A clear and credible medium-term fiscal strategy would help to reduce the uncertainty premium in New Zealand's interest rates. Lower interest rates would in turn give much needed impetus to the present recovery in economic activity.

The GST increase announced in the 21 March Economic Statement will temporarily reverse the progress made in reducing the CPI inflation. After falling to 4 per cent in the year to March 1989, the increase in the CPI is expected to peak at 6.3 per cent in the year to December 1989. Provided that the GST increase does not flow through into higher wages, CPI inflation is then expected to fall to 3.1 per cent in the year to March 1991. This outcome would be consistent with a further decline into the 0-2 per cent range over the following two years. Price stability, together with the efficiency enhancing structural changes in the economy, will provide a solid foundation for sustainable improvements in living standards during the 1990s and beyond.

[1] Official measure, which is also known as the Household Labour Force Survey (HLFS) measure.