Interview with Dr Don Brash

The following is an edited transcript of an interview with the Governor, Dr Don Brash, which was carried on New Zealand BBC on 5 August 1993.

Lindsay Perigo:

Our Thursday interview this morning is with Reserve Bank Governor, Dr Don Brash. Now, just a note here for those in the money markets. This interview was recorded last Friday, and Dr Brash's comments about currency levels pertain to the levels then, and not this morning.

Well, Dr Brash, it's good to see you here in the studio, in the flesh. It's very difficult to persuade the Governor of the Reserve Bank ever to come out of hiding. Of course, if you so much as sneeze the money markets catch cold. Why this sensitivity to what you say?

Dr Don Brash:

Well, it's something I have learned over the last four or five years — that central bank governors do appear to have a marked effect on financial markets, and I guess that's because ultimately the central bank can influence the level of short-term interest rates and therefore the level of exchange rate, and therefore any sign which betrays an intention to change those short- term interest rates tends to have a pretty dramatic effect on financial markets quite quickly.

Perigo:

Now, who is it exactly who pays such close attention to what you say, and reacts?

Brash:

Large numbers of people in the New Zealand financial markets — banks, bank treasurers, bank foreign exchange dealers, bank money market dealers — but also corporate treasurers in New Zealand, in Wellington and Auckland, but also offshore. Quite a large number of foreigners are now investing in the New Zealand market, and they watch very carefully what's happening in interest rate markets and in foreign exchange rate markets here.

Perigo:

You say you've learned from experience to be careful about what you say. Have there been some, shall we say, untoward incidents, in the past?

Brash:

Well, when I first became Governor, I believed very much in openness, transparency, *et cetera*, and made no attempt to speak off the record — I spoke on the record as a matter of principle. I got a large amount of media coverage to the point, indeed, where I think Tom Scott did a cartoon about me, suggesting I was going to have my office wired for sound so that I could broadcast discussions about monetary policy live. And I began to appreciate that there were some significant dangers in that, and that was creating undesirable money market turbulence.

Perigo:

It's a sensitivity, though, that you exploit when you want to, in that if you want to influence the currency up or down, for example, then you will make certain noises and then await the response.

Brash:

That's true, and in a sense that's one of the responsibilities of the office. We have, as you know, a single statutory responsibility, namely to achieve price stability and maintain it. We've achieved it. Now, the task is to maintain it and we have to adjust monetary conditions from time to time, to keep that on track.

Perigo:

And we had an example earlier this year when the currency was dropping alarmingly low, in your view, and you talked it up by threatening to intervene. That didn't totally work and you did intervene. What does a Reserve Bank Governor do when he intervenes? What do we mean by "intervention"?

Brash:

Well, just to go back to that point, you're absolutely right. We made a comment, we expected that to have an effect on the financial market and it didn't. We were surprised at that because over the last few years, making it clear what our intentions are has normally been sufficient to produce the effect we want. I guess for that to work in the longer term, one has to be willing occasionally to back up words with action, and in this case we had to do that. In the particular case to which you refer, early January this year, the exchange rate had been weak for a number of weeks, and at that point when the markets weren't, apparently, willing to take hints we did decide to adjust monetary conditions, essentially by reducing settlement cash. Now, trying to explain settlement cash in a few minutes on radio isn't going to be easy and I don't think I'll try, but essentially, banks have a certain amount of cash on balance, in aggregate, with the Reserve Bank, and we adjust short-term interest rates either by changing that balance through open market operations or by threatening to do so. On this occasion we actually reduced the aggregate balance that we were targeting, from $20 million in total between the banks, down to zero.

Perigo:

How does that, then, affect the value of the currency, which is what you were aiming at?

Brash:

Well, dropping the balance of settlement cash tends to push up short-term interest rates and because that happens, holding New Zealand dollars becomes a more attractive proposition. Foreigners and, indeed, domestic investors, can get higher rates of interest in New Zealand dollars than previously, that makes them less inclined to take money out of the country or more inclined to bring money into the country, and both of those things tend to push up the New Zealand dollar.

Perigo:

Now, why were you anxious about the value of the currency at the time?

Brash:

Mainly because changes in the level of the New Zealand dollar have an effect on the rate of change of prices, in other words, on inflation, in New Zealand. That's true of any small country which is fairly open: the level of the exchange rate, or the change in the exchange rate, tends to affect the inflation rate. And we were concerned that with the exchange rate as it then was, we were running the risk of inflation coming in above 2 percent which is the top of our target.

Perigo:

And then you'd lose your job.

Brash

Exactly right.

Perigo:

Potentially. But how do you figure out the inflationary impact of the currency level. I mean, how did you know that if it went below a certain point we would get inflation of above 2 percent?

Brash:

It's not possible to make an absolute precise calculation, but over the last several years in New Zealand a lot of people have made studies on the impact of a change in the exchange rate on the rate of inflation and there's a general agreement, I think, that an exchange rate movement of X will produce an inflation rate change of Y. Now, precisely what Y is, is a little bit contentious but there's a fairly general agreement that it will have an effect which is reasonably predictable over a period of six to 15 months.

Perigo:

So, what is the bottom level for the exchange rate you're comfortable with, at the moment?

Brash:

We don't, in fact, make known that range, either the top or the bottom, but financial markets tend to have a reasonably good view of that because they can make the same kinds of calculations that we do. And in addition, of course, from time to time when either the top or the bottom are actually reached or breached, then we react and the market says "Aha! - your floor is X." Now, on 6th of January the widespread market view was that our floor was 53.0 on the trade weighted index. One of the reasons we don't announce our top or our bottom is that it isn't a mechanistic thing. We look at the whole range of things impacting on inflation and judge what the appropriate bottom and the appropriate top is — so it's changing all the time.

Perigo:

But you're not going to publicly dispute that it was 53.0?

Brash:

Well, I'm not going to publicly dispute that it was 53.0 last January.

Perigo:

I see. We've got "neither confirm nor deny" here. If you believe in the marketplace, though, as I think you do, why not leave this to the market, as with all other decisions?

Brash:

Well, I guess a central bank, almost by the nature of the case is not a market operation in that we have a monopoly right to issue the currency, the New Zealand dollar. There are some who say we should not enjoy that monopoly right and I think there are good reasons for that point of view. I think there are also quite good reasons against that point of view, I'm bound to say. I don't think I want to get into a long debate about free banking versus non—free banking but if you accept that a central bank has a role, and virtually every country in the world now, I think, has a central bank, then by definition it is a market intervention and in the New Zealand case Government has simply said, "We want the central bank to use that intervention for the single purpose of maintaining price stability." If we're going to do that we have to form a view from time to time of what the exchange rate consistent with price stability is going to be.

Perigo:

The currency, of course, is very strong at the moment. You certainly don't have to worry about it dropping too low right now. Why is it strong?

Brash:

Well, when you say it's very strong — funnily enough, it's only appreciated since the 6th of January by about 3 or 4 percent against the index. When people talk about it being very strong they're typically looking at the New Zealand/ Australian rate. Now that's certainly true — the New Zealand dollar against the Australian dollar has appreciated quite significantly ...

Perigo:

Is that because people, at long last, can tell the difference?

Brash:

Well, they can tell the difference and there's a feeling that the Australian dollar has been somewhat over—valued. Whether it is now, of course, is a matter for judgment, but the Australian dollar has fallen markedly against most currencies, including the New Zealand dollar so, in other words, we have appreciated against the Australian dollar. We have also appreciated somewhat against the US dollar, but over the same period we've depreciated against the yen. There has been, as I say, about a 3-4 percent appreciation of the New Zealand dollar since January.

Perigo:

There's nothing in the currency level that worries you at all?

Brash:

Well, I think the market recognises that at some point the appreciation of the New Zealand dollar would threaten the bottom of our inflation target which, of course, is zero. People often forget that our target is not to get inflation simply below 2 percent. It's to get it between 0 and 2 percent - which implies we've not only

got a floor to the exchange rate, we've also got a view that at some point it would become too high. The market's judgment on that seems to be that at current levels of the trade weighted index, we're obviously much closer to the top of that range than we were back in January, and that's reflected in the fact that our short-term interest rates have fallen quite sharply. They've fallen because the market knows that at some point the appreciation would reach the point where we would be forced to ease interest rates to prevent it rising too much further. Because they know that, interest rates ease by themselves, and because of that we need to take no action.

Perigo:

Let's get right down to basics here. How do you define inflation? Is it the simple fact of rising prices or is it too much literal cash sloshing around in the system? What is it?

Brash:

Well, I guess — distinguishing between what inflation is and what causes it — inflation is essentially the rise in prices generally. We're not talking now about the rise of a single price or the change in, let's say, log prices. The fact that log prices have gone up doesn't mean there's inflation as such, it means that there's been a shift in either the supply or demand for logs. So, we're not trying to prevent individual prices from changing either up or down. We're trying to prevent a generalised change in the price level which, as your question implies, tends to be driven by an excess of money in the system. Now, having said that, I don't want to be labelled too simplistically "a monetarist", because most central banks have discovered that targeting money supply as such is a rather imperfect way of targeting inflation, so that while we do look at money supply growth, we look at a range of other things, as well.

Perigo:

What causes there to be too much money in the system? Who puts it there?

Brash:

Well, in the New Zealand case the supply of money is very much a function of the way in which Government funds its own deficit, it's a function of the way the banking system as a whole is creating new credit, and so on. Again, it's a fairly technical issue to get into discussing, but we seek to influence that by changing the price of money — in other words, the interest rate and that affects people's willingness to borrow, people's willingness to save.

Perigo:

What's wrong with inflation? It still has its devotees, there are still people who are saying, "We could get much more growth if we were much looser with the money supply."

Brash:

Fortunately, those people are fewer and fewer in New Zealand and, indeed, around the world. I guess if one takes a sort of *reductio ad absurdum* argument, one only needs to look at some of the countries where hyper-inflation exists — former Yugoslavia, former Soviet Union, where inflation of more than 1000

percent rages but where the economy is extremely sick (real production is very, very reduced). I think there used to be a view that higher inflation would produce faster growth and lower unemployment. That view, I think, is now substantially discredited — certainly in the economics profession. We recognise certainly there is a tradeoff between inflation and unemployment in the very short term but there is not a tradeoff in the longer term. That's partly based on theoretical argument but also partly based on the experience of many countries in the last 20 years. There doesn't seem to be any evidence that the low inflation countries have higher unemployment.

Perigo:

And recent evidence would suggest we can certainly have growth without inflation but it was something of an experiment, wasn't it? No-one was too certain when we set out upon this route.

Brash:

Well, it was regarded as an experiment in New Zealand. I think internationally it's been well accepted, now, for some years, that there isn't a tradeoff in the longer term between growth and inflation. One only needs to look at Japan, for example — a country which has had very rapid growth through most of the last 20 years but which has had a very good inflation record. Similarly, places like Singapore, until recently Germany, Switzerland and so on — they had good growth records and low inflation. Conversely, countries which have had quite high inflation — places like Spain, for example — have not done particularly well on unemployment. So, increasingly it was recognised there isn't the tradeoff of that kind.

Perigo:

And increasingly the Reserve Bank Act is being attended to by people overseas as an example that they might want to emulate. Do you think that this will happen, for example with the Bank of England — they've been looking at it. Is it an idea whose time has come, do you think?

Brash:

I don't want to make a comment, of course, on what the Bank of England should do. But I'm bound to say that I think the New Zealand framework is a particularly elegant one and I can say that without any sense of modesty or immodesty because I didn't design it — it was basically designed before I became Governor. It's elegant because it does two very important things which have not been done in the same way anywhere else in the world. First, it recognises an explicit role for Government in the choice of targets. The New Zealand framework has a law which says monetary policy should be targeted at price stability, but it doesn't define what that is. It leaves to the Government of the day the right to specify what that is, in a written contract with the Governor of the Bank. That contract has to be in writing, as I say, and it has to be in public. But it recognises the right of the democratically-elected Government to choose the target but it also obliges them to make that public. On the other hand, it also marries that with operating independence in terms of the implementation of policy, and no other central bank has achieved that particular blend in quite the same way.

Perigo:

Well again, do you think that is an idea whose time has come?

Brash:

I think it's very attractive and I think a lot of other countries, as you say, are looking at it. Countries in Europe, countries in Asia and, indeed, even one or two countries in Latin America have sought information on the nature of the framework.

Perigo:

Let's talk about the whole banking system in New Zealand. I understand there's a process going on right now of reviewing the prudential supervision by the Reserve Bank of the banking system. Are you wanting more of a role for the Reserve Bank or less of a role?

Brash:

Well, a different role, I think is the better way of putting it. Traditionally, we have gathered a lot of information on banks which has not been available to the public, and what we are looking at now is a different kind of system whereby we will continue to register banks, we will continue to monitor banks, we will continue to have a crisis management role in the case of a bank getting into difficulties, but most of the information which we will use to monitor banks will also be available to the public. We are saying, there should be much more disclosure by banks of their balance sheet position, their profit and loss position, their risk concentration position *et cetera*. We are also saying, banks should be obliged to get and display credit ratings so that people can have a chance of assessing whether or not their banks are very strong or only moderately strong. Now, I suspect that most people will have no interest at all and no ability at all to read quarterly balance sheets from banks. We're not assuming that they will. What we are assuming is that because a small proportion of bank customers will, that bank managements will change their behaviour to a more prudent policy.

Perigo:

Does that state of affairs, though, have to be regulated? I wonder, going back to the idea of a free banking system, wouldn't, in a free banking system, banks monitor their own performance or at least employ people to monitor their performance and let it be known publicly?

Brash:

There is that point of view and it's one which I think has got quite a lot of theoretical appeal. In the present situation in New Zealand we have a statutory responsibility to register and supervise banks and we think that, particularly given the nature of the present payment system in New Zealand which makes the whole banking system somewhat vulnerable were a bank to fail, what we're proposing is the best solution.