The Relationship Between Price Stability And Growth

Modified notes from an address by Reserve Bank Governor, Dr Don Brash, to the Wellington Chamber of Commerce on Wednesday, 23 February 1994.

As you may know, there was quite a lot of debate earlier this year about what the Reserve Bank should or shouldn't be trying to achieve. It seems to me that much of this discussion has been pretty murky or confused. But the basic issues being argued over are important. Today I'd like to try to shed a bit of clarifying light on some of the arguments that have been made so that we can all see them for what they are and for what they aren't.

One of the things that seems to have triggered this flurry of debate was the Reserve Bank's December Monetary Policy Statement. In that Statement we indicated that the outlook for 1994 was for growth in the economy to remain robust and for inflation to remain comfortably low. I don't recall anyone objecting to that part of the Statement. But we also sounded a note of caution regarding the longer-term outlook. Our concern was that unduly strong expansion of activity and spending could lead to upward pressure on inflation. And if this happens — which is not yet a foregone conclusion — some firming of monetary conditions would be called for.

The idea that monetary policy should act to head off inflation is, of course, the central concept in the Reserve Bank of New Zealand Act, which has governed the Bank's actions since 1989. But quite apart from our statutory obligation to maintain price stability, it seems to me to be plain common sense that, if the economy begins to show signs of over-heating and threatens to rekindle inflation, that is the time to apply a touch of the monetary "brakes".

I think it also needs emphasising that monetary policy stands as ready to head off *deflation* — that is, falling prices — as to head off a resurgence of inflation. In fact, for most of the period since 1990, monetary policy could be generally described as having leaned towards easing, rather than towards firmer or even unchanged conditions. As inflation and inflation expectations subsided over the period, interest rates in New Zealand have come down a long way. Yields on 90 day bank bills, for example, have fallen from over 14 percent in 1990 to under 5 percent currently. Similarly, yields on 5-year bonds have fallen from nearly 13 percent to a little over 5 percent. Over the same period, the New Zealand dollar depreciated by about 7 percent, on average, against the currencies of our major trading partners. Had the Reserve Bank not accommodated or encouraged this sort of easing in monetary conditions, we would almost certainly be seeing falling prices today. In short, when the goal of monetary policy is price stability, policy will tend towards ease when there is plenty of spare capacity in the economy and downward pressure on inflation. But as the economy expands, and spare capacity gets taken up, increased inflation pressures become more likely. In such circumstances, monetary policy needs to shift — or at least be prepared to shift — towards restraint.

Lately, however, we've heard a variety of voices arguing that, for one reason or another, monetary policy should not shift towards restraint even if inflation pressures re-emerge.

In my view, these arguments all have one key – but incorrect – element in common: that there are some real gains or benefits to be had from accepting higher inflation. Now, if you accept that line of reasoning you will also be led to take one of two views on the Reserve Bank. The first is that, for whatever reasons, the Bank wants to deny those supposed benefits to New Zealanders. The slightly more generous view is that the Bank is simply stuck with a mandate that is much too narrowly focused on price stability to the exclusion of other worthy aims.

Both of these views are essentially fantasy. And that is because both are based on a myth. As with most myths, this one comes in several slightly different versions. What I want to do in the remainder of my remarks today is to show how they all boil down to essentially the same false promise. That is a promise that some economic good can be had at the supposedly negligible cost of more inflation.

One version of the myth is that if we were willing to accept a higher rate of inflation we could have more economic growth. More often we seem to hear the negative version of the myth. In this version, any action by the Bank to keep inflation from rising is bound to hurt growth. A slightly more sophisticated variation on the theme is that low inflation and good growth are just not compatible. So if we have to choose between the two, let's go for growth. It doesn't really matter how it's phrased, the bottom line is the same and it's wrong.

In a way it's too bad that a bit more inflation couldn't get us a bit more real growth on a sustainable basis. If more inflation could give us more growth, not just today but on a lasting basis, why not go for a lot more inflation so that we could have a lot more growth? If this doesn't sound quite right, let me assure you — it isn't!

Part of the problem with the argument is that more inflation isn't costless. More inflation damages the working of the economy in a host of different ways, affecting nearly everyone. Spending and savings decisions, borrowing and investment decisions all end up being distorted by inflation, and those distortions actually hamper the growth of the economy. So even die-hard believers in the myth would probably admit that more inflation isn't costless and that at some point more inflation would do more harm than good.

The best evidence that we have, from our own research and similar work around the world, is that even low rates of inflation damage the economy. And that is partly why we have a target range for inflation of 0 to 2 percent. It would be interesting to know from believers in the myth at what point they think the damage from inflation would outweigh the supposed growth benefits. In other words, what would they say is too high a rate of inflation? Frankly, I suspect that most advocates of using inflation to boost growth don't really have an upper limit clearly in mind. If pressed, the answer would probably be that no matter how high the inflation rate got, just a bit more inflation would bring more growth and a bit less inflation would hurt growth.

This brings me to the second problem with the myth that more inflation can bring more growth. What proponents of the myth gloss over is *how* more inflation would generate more growth. If you cut through all the economic theory and jargon, the way to get and keep more growth from more inflation is by fooling people. Fooling people working for a wage or salary, fooling people trying to save and fooling people who depend on their savings. As long as they stay fooled, these sorts of people — which means most ordinary people — lose out from more inflation. To be sure, a few people gain: the owners or shareholders of companies whose prices rise faster than their wages, taxes and other costs may gain. And people or companies with large debts may gain. So one thing that more inflation does is redistribute income in an arbitrary way. Mostly, it takes income away from people who put faith in the value of New Zealand's money and gives some to those who don't.

Another bit of the myth that gets glossed over is that any extra growth that you might get from more inflation is bound to be short-lived. That is simply because *getting* that extra growth depends on people *being* fooled by inflation, and *keeping* the extra growth depends on people *staying* fooled. Well, fooling people isn't that hard — at least if they believe you — so we probably could squeeze out some extra growth by promising price stability but delivering inflation. What is a lot harder to do is *keeping* people fooled — and that's what we would need to do to keep the extra growth. The problem is that it's hard to imagine most people staying fooled for too long when they find that their salaries, savings and pensions just don't go as far as they did before.

How long people can be fooled or tricked by inflation depends importantly on how often and how recently they have been fooled in the past. The more experience that people have with inflation, and the more recent that experience, the less likely they are to be fooled again. Unfortunately, New Zealanders have had altogether too much experience with inflation and all too recently. So in this country, at least, any gains from more inflation are likely to be even more temporary than elsewhere.

One of the groups that is especially sensitive to inflation is financial markets. They very quickly build inflation fears into interest rates. Back in early 1986, inflation in New Zealand was running at 13 percent and our long-term interest rates, at over 18 percent, were fully 9 percentage points higher than comparable US rates. Today, with inflation of about one-and-a-half percent, and growing confidence in our commitment to maintaining price stability, our long-term interest rates have dipped slightly below US rates. Financial markets have rewarded New Zealand for getting inflation down.

We can be just as sure that the markets would penalise us if we decided to have more inflation. Indeed, we would be penalised even for *thinking about* tolerating more inflation. If the Reserve Bank Act, for example, were amended to add growth or some other objective to the inflation objective, markets would quickly conclude that in some circumstances, our policy might be diverted from controlling inflation. Even the chance of such a diversion would be reflected in higher interest rates facing New Zealand borrowers. What this means is that if we gave ourselves the option of having more inflation, but didn't use it, we would simply have higher interest rates and, consequently, lower growth. And if we didn't want that, we would have to try to boost growth with more inflation - validating the market's fears - and suffer the long-term damage of a more inflationary economy. The bottom line is that while having what some would call a more 'flexible' monetary policy may sound good, giving ourselves that flexibility is bound to carry a price tag in the form of interest rates being higher than otherwise. It doesn't make much sense to me to pay that price unless we are really sure it's worth it.

So much for the arguments. Now what about the evidence? If we look around the world, what do we see? We see countries like Japan and Germany or Singapore and Austria that have managed to combine low inflation with good growth for years. We see even more countries where resorting to high rates of inflation has not prevented growth from stagnating or worse. The basic message from overseas evidence seems pretty clear: sustained good growth doesn't depend on inflation, just as low inflation doesn't guarantee stagnation.

Another thing that is readily evident overseas is that after the inflationary experiences of the 1970s, central banks in every major industrial country, and a good many developing countries as well, came to the same conclusion as we did here: more inflation ends up doing more harm than good.

In my view, the most obvious lesson to be drawn from this experience is that in New Zealand, as elsewhere, achieving good, solid and sustained growth just doesn't depend on being more tolerant of inflation.

It seems to me that once you look at all closely at the myth that more inflation can give you more growth, it just falls apart. What you may get— for just as long as you can keep people fooled — is a temporary increase in growth and an arbitrary redistribution of income. Afterwards, all that would be left would be the higher inflation and the lasting damage it does.

So over the long haul, which is what monetary policy needs to be geared to, the reality —in contrast with the myth — is that, far from promoting growth, higher inflation is likely to hinder long-term growth.

Let me now turn to another version of the myth. In this version, a bit more inflation would help get unemployment down. This version too is often heard in the negative: by keeping to a low inflation target, the Reserve Bank is condemning the country to permanently high unemployment. If the myth were true, it wouldn't make sense just to *add* employment to the Bank's inflation target, it would make sense to *replace* the inflation target with an employment target. Suggesting that we have both is just fudging the issue.

The problem with the myth is that more inflation just doesn't reduce unemployment in a sustainable way. And for the same reasons that inflation can't manufacture sustained increases in growth. For a while, more inflation probably can generate some more jobs by fooling people into accepting wages that will buy them less than they were counting on. As soon as people stopped being fooled — and it doesn't take long — wages would start to chase prices as people sought to recoup what they had lost to inflation. And in the process, the temporary increase in employment would evaporate, leaving inflation, and the damage it does, as the main residue.

Now if you don't believe that that would happen, ask yourself this: suppose that I proposed that everyone in the country should take, say, a ten percent cut in pay, in savings and pensions, but still pay the same prices in the shops. How many people do you think would go along with that idea not just willingly but permanently? If the answer is not too many, then inflation won't generate permanent gains in jobs. And that's because more inflation generates jobs by cutting people's wages in relation to the prices they have to pay.

This isn't just abstract theory; using more inflation to promote growth and employment has been tried in many places, and nowhere as doggedly as in New Zealand. And everywhere it has failed because people don't stay fooled long when they find that higher wages wind up buying fewer groceries to take home.

Once again, the idea that more inflation will bring any sort of lasting benefit — in this case a better outcome for employment — doesn't really stand up to much scrutiny. Indeed, I believe that the opposite is true: keeping inflation low is the best contribution monetary policy can make to achieving lasting increases in employment and lasting reductions in unemployment.

The issue is not whether stubbornly high unemployment is a problem. There is no question that it puts a tremendous strain on the economic and social fabric of the country. The question is what, if any, useful and lasting contribution monetary policy can make to solving the problem of unemployment. Reason and hard evidence suggest that there really isn't much good that monetary policy can do other than to provide the sort of low inflation environment in which markets work best. And when markets work better, growth and employment will be higher than otherwise.

I would now like to discuss one last version of the myth that more inflation can bring lasting benefits. In this version, keeping the exchange rate down can bring a host of good things like trade surpluses, export-led growth and more jobs. It certainly has a nice ring to it and if it were really true, well maybe the Bank should have keeping the exchange rate competitive as its target. The only problem, once again, is that the myth is not really true. Instead, it's just another recipe for deception, unfairness and, ultimately, worse economic performance.

Proponents of this particular version of the myth conveniently ignore a couple of fatal problems with the argument. The first is that financial markets would react in a decidedly unhelpful way. If the Bank had a policy of trying to maintain a low and competitive exchange rate, investing in New Zealand dollar assets would become a one-way bet. Down. An immediate consequence would be that investors and savers, both here and abroad, would demand much higher interest rates on lending in New Zealand dollars. So right away, this supposedly growth promoting policy would raise the cost of investment for firms in New Zealand.

But there is an even more serious difficulty with the idea of getting any lasting benefit from a policy of devaluation. And by now it may be a familiar problem. Boosting exports through devaluation only works as long as people can be fooled. If we pushed down the exchange rate, the New Zealand dollar prices of our exports would rise. But so would the prices of our imports, as well as the prices of many things — like food — that we consume as well as export.

As usual, of course, there would be both winners and losers in all of this. As long as wage earners didn't twig to the fact that their wages were being eaten up by inflation, exporters' profits would rise and this in turn would stimulate investment, employment and output in export industries. What tends to be left out of this glowing picture is that the rest of the economy would merely face the higher prices.

As soon as people realised that their wages were being eroded by inflation, the game would be over. Exporters' costs would quickly rise and, presumably, the Reserve Bank would be under pressure to push the exchange rate down again in a bid to restore lost competitiveness. This sort of policy has been tried many times and in many places, including New Zealand. And the outcome is always the same. Eventually, the competitive edge delivered by devaluation is blunted by the inflation that follows. So that once again all that is left at the end of the day is the damage from inflation. Or worse. Because when a country tries to use devaluation to promote competitiveness, producers tend to lose sight of the things that generate lasting improvements in competitiveness. Things like making products as efficiently as possible, things like improving quality and follow-up service, things like innovative marketing.

The main point to emphasise, however, is that using monetary policy to promote competitiveness is fundamentally a recipe for inflation, and in the same way as using inflation to promote growth or employment.

Growth, employment and a competitive export sector are all worthy objectives for New Zealand. But the gist of what I have been saying today is that the idea that more inflation can help us reach those objectives in any sort of sustainable or equitable way is just a myth. What we can say is that by keeping inflation down — and in a way that convinces individuals and markets that inflation will stay down — monetary policy can help provide the basis for lasting improvements in growth, employment and competitiveness.

Let me say that in rebutting the notion that more inflation will promote growth, employment or exports, I'm not revealing any new universal truths. From the early 1970s until the mid-1980s, New Zealand put these variations on the myth to the test. We tried to boost growth, employment and exports with endless doses of inflation and devaluation. And it didn't work.

The Reserve Bank Act, directing monetary policy squarely at controlling inflation, is the product of lessons learned at an enormous cost to New Zealand. And in my view, I think we are now really starting to reap some of the benefits of price stability. Yet it seems that old myths are hard to lay to rest, no matter how often they are shown to be wrong. But it would be the height of folly for us to once again be seduced by such myths, and to turn our backs on the harsh lessons of our recent history.

One final comment. I have argued that monetary policy makes its best contribution to all New Zealanders by focusing solely on price stability. I want to say also that I am tired of hearing the New Zealand monetary policy framework attacked as 'right wing'. This criticism is presumably meant to imply that price stability somehow helps the 'rich and powerful' but hurts 'ordinary New Zealanders'. In my view, this is not only nonsense, it is the very reverse of the truth: the wealthy are usually very adept at protecting themselves from high inflation; the poor frequently don't have that option. Political parties who profess a concern for the poor should be in the forefront of those supporting the Reserve Bank Act.