Economic policy issues facing the nation

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Introduction

Mr Chairman, I very much appreciate being invited once again to address a breakfast meeting of the Auckland Chamber of Commerce. The Auckland Chamber plays a very vital role in assisting the business community in this region and, if I may say so, reminding Wellington policy makers of the issues which are important to that business community. (And I make that compliment not *only* because two members of the Chamber's Council are also directors of the Reserve Bank - which among other things helps to ensure that the views of the members of the Auckland business community receive a full hearing within the Bank.)

I note that some of the publicity associated with this speech has me addressing the question 'Is the Reserve Bank paranoid about Auckland?' I did contemplate addressing this subject at one stage, but decided that doing so would make for a very short speech: no, we are not paranoid about Auckland.

Auckland is a vitally important part of the New Zealand economy. The Reserve Bank certainly recognises that, and devotes considerable effort to ensuring we have a good understanding of what is going on here.

But far from being paranoid about Auckland, or even Auckland property prices, in recent months I have been in the forefront of those pointing out that, while the median house price in Auckland did rise by 36 percent over the two years to December 1995, it rose in Taranaki by 22 percent, in Southland by 18 percent, and in Otago and the Waikato by 16 percent over the same period. And that the average price per hectare of dairy farms sold rose by 70 percent, and of fattening farms sold by 84 percent, over the same two-year period.

Auckland property prices, like rising real estate prices more generally, do tell us some important things about inflationary expectations in the property market and about overall demand conditions. They are certainly *relevant* to monetary policy, but they are certainly not the only determinant of monetary policy

Enough of Auckland property prices, though I will come back briefly to their relevance to current monetary conditions a little later.

Most of my speeches deal solely with monetary policy and the inflation outlook, with substantial references also to interest rates and the exchange rate. This morning I am challenged by your invitation to address a rather broader subject, namely 'Economic issues facing the nation'. The timing is opportune: just two weeks ago today, the Bank released its latest *Economic Projections*, and these have attracted quite a lot of media comment. Yes, these projections suggest that by the middle of next year underlying inflation will be back in the middle part of the 0 to 2 percent target which the Bank has been set by successive Governments. But to many people nothing else about the projections looks particularly encouraging.

Growth in real GDP is projected to have been only 1.5 percent between the March quarter of 1995 and the March quarter of 1996, to be only 2.3 percent in the year to March 1997, and to be only 3.0 percent in the year to March 1998. Where is the 5 or 6 percent growth of 1993 and 1994?

Unemployment is projected to rise from its recent level of 6.1 percent of the labour force to 6.9 percent, and to stabilise at around that level. Where are the continued reductions in unemployment which we had all come to expect, and which we had all fervently hoped for?

The current account deficit of the balance of payments is projected to have been 4.3 percent of GDP in the year to March 1996, and to be higher again, at 5.2 percent of GDP, in the year to March 1998. Where are the balance of payments surpluses which many commentators were projecting only a few short months ago?

What has gone wrong? Weren't we all promised that low inflation would solve all our problems -that low inflation would ensure strong growth in output and employment, and would improve our international competitiveness, thus ensuring balance of payments problems were dealt with once and for all? Is the Reserve Bank killing the real economy, and exporters in particular, by an unrealistically ambitious goal of delivering inflation below that of our trading partners? These questions are being increasingly asked, even by those who have long supported the desirability of low inflation, and it is important that I make my own position on these issues very clear.

But before doing so, it is important also that nobody loses sight of what *has* been accomplished in recent years. The economic growth which the Bank now judges to be sustainable over the medium-term, 3 to 3.5 percent per annum, is not only appreciably faster than the trend growth we were capable of in the seventies and eighties but is also appreciably faster than the sustainable growth now judged feasible in, say, the United States, the United Kingdom, or Germany.

Moreover, employment growth has been very rapid in recent years, to the point where our rate of unemployment is now one of the lowest in the developed world, and certainly well below unemployment levels in both western Europe and Australia.

And this together with inflation which *has been*, over the last five years, and *should be*, over the years covered by the Bank's *Economic Projections,* very low by the standards both of our own history and of most other countries.

But the questions and the doubts remain.

It will probably surprise nobody in this room that I remain totally convinced of two propositions.

First, I am totally convinced that, while monetary policy *can* influence a country's inflation rate, it can *not* be used directly to engineer a sustainable increase in economic growth, or a sustainable increase in employment, or a sustainable improvement in export competitiveness. I think that this is now the virtually unanimous view of economists around the world, and it is borne out by the experience of all countries over the last several decades. I have seen no evidence that being more tolerant of inflation will yield sustainable improvements in economic performance.

Of course, looser monetary policy can *for a while* give a boost to economic growth and to employment, but the gains don't last, while the inflation hangover does. The sustained result is not more growth or more employment but instead the insidious damage of higher inflation, and sooner or later the social and economic costs of getting inflation down again.

Secondly, given the first proposition (that monetary policy can not be used directly to engineer sustainably better growth, employment or balance of payments outcomes), the most sensible inflation rate for monetary policy to target is *no* inflation, since any other rate of inflation involves both social and economic costs.

The social costs arise from the arbitrary redistribution of income and wealth which inflation almost always entails.

The economic costs arise in a number of ways, but in New Zealand at least arise in significant part from the interaction of inflation with a tax system designed on the assumption of no inflation: that interaction results in substantial distortion of the allocation of investment, because investment in productive activities tends to be substantially over-taxed in an inflationary environment while investment in real estate tends to be substantially under-taxed. I suspect that inflation does a great deal of indirect damage also, by making it relatively easy for companies to give the appearance of earning good profits, even while failing to improve their product quality, failing to improve their production efficiency, and failing to improve their marketing - the things which ultimately make for economic success.

As for whether targeting an inflation rate below that of our trading partners involves penalising our export sector, I know of absolutely no grounds for believing this to be the case. With an adjustable or floating exchange rate, New Zealand can choose its own inflation rate, irrespective of the inflation rates which our trading partners choose. Through the seventies and much of the eighties, we chose an inflation rate well above that of our trading partners, and our currency depreciated heavily to reflect that relatively poor inflation performance. In recent years, we have chosen to inflate at a rate somewhat below that of our trading partners, and our currency has been appreciating, in part to reflect that fact. Just as depreciation to reflect relatively poor inflation performance did not *assist* exporters in the seventies and eighties, an appreciation which merely reflects relatively better inflation performance should not *damage* exporters. (Of course, that is not to deny that, from time to time, the exchange rate may move to reflect factors other than relative inflation performance, although over the last three decades the cumulative impact of these additional movements has been quite modest.)

Low inflation helps economic performance but does not *guarantee* growth

But though average price stability is clearly the best contribution which monetary policy can make to the long-term performance of the economy, price stability does not *guarantee* rapid economic growth. Price stability does not *guarantee* low unemployment. Price stability does not *guarantee* the competitiveness of exporters, or equilibrium in the balance of payments.

Ultimately, economic growth depends not on monetary factors but on real factors - on how fast the labour force is growing, on how skilled the labour force is, on how much capital that labour force has to work with, on the technology embodied in the capital, on the efficiency of the price system in signalling where capital can be most productively invested, on the nature of regulations and restrictions which inhibit the effective working of the price system, and a host of other *real* factors. Prices which are, on average, stable assist the pricing system to work effectively, and thereby help to ensure that investment takes place in the most economically sensible places. Prices which are, on average, stable tend to encourage saving, and thereby help to finance additional investment. But stable prices won't of themselves make public sector enterprises more efficient; or improve the quality of the education system; or move resources out of highly protected sectors into those which can be competitive on international markets; or improve the marketing of commodity exports; or even give us East-Asian-type savings rates.

I would argue strongly that price stability has been helpful to the improved performance of the New Zealand economy in recent years, but I have never claimed for a moment that price stability has been the sole reason for our better performance, nor that price stability guarantees us strong growth in the future. Our very much improved growth performance in the recent past has been the result of a whole range of policy changes - of reduced protection and regulation in the private sector, of corporatisation and privatisation of many formerly inefficient public sector enterprises, of a vastly less distorting tax structure, of port reform, of labour market reform, and all the rest.

If we want to build on that achievement in the years ahead, we must constantly be seeking areas where productivity can be further improved. At this stage, the aggregate numbers for the economy as a whole suggest that trend productivity growth is no more than 1.5 percent per annum. If that turns out to be the case (and 1.5 percent is close to productivity growth in other mature economies, such as the United States and Australia), total growth in GDP could well be 3 percent or more because of growth in the labour force. But growth in real income *per head*, which must surely be the real objective of economic policy, will not exceed 1.5 percent annually. If we want faster growth in spending than that, we can in the short term borrow to supplement our income but, as we learned in the seventies and early eighties, that is ultimately futile. In the longer term, higher incomes per head, and the higher spending that that can bring, can only come from finding ways to accelerate productivity growth.

And how do we do that? Certainly not by debasing the currency through tolerating inflation. The very rapid growth of the countries of East Asia is in part simply the result of their being able to pick up 'off the shelf' modern technologies, which have taken decades to develop elsewhere. In other words, there is a substantial element of 'catch-up' in the fast growth of East Asia. But the wealth which has occasioned so much envy on the part of some New Zealanders has also been achieved in a particular cultural environment - a cultural environment which places enormous emphasis on family self-reliance, which abjures reliance on the state, which as a consequence generates a savings rate roughly double the New Zealand rate, which pursues education and training with a passion, which regards material affluence as a highly desirable goal. New Zealanders have, implicitly at least, *chosen* a slower growth path, by placing little emphasis on saving, by placing a more modest value on education and training, by valuing other goals more highly than affluence.

I recall seeing a television programme some two or three years ago about Asian students in our schools. The programme included comments from two New Zealand children that they resented the fact that the Asian children worked much harder than they did. I don't think New Zealand children should be forced to work as hard as Asian children do, but I think it is important for New Zealand children to realise that they live in a world where those who work hard will end up with higher incomes and more wealth than those who choose to work less hard. If we are only prepared to pay for beer, we won't be drinking a lot of champagne. And that is entirely appropriate.

Low inflation helps economic performance but does not *guarantee* low unemployment

What about unemployment? Once upon a time, policy makers used to believe that there was a trade-off between inflation and unemployment; in other words, that if a country wanted to maintain a low inflation rate it inevitably had to accept a high unemployment rate, and vice versa. We now know that that is not the case: there is no trade-off, at least in the medium- and long-term. That is clearly established not only in the economic literature but also in the practical experience of many countries, including New Zealand itself.

We do know that, *at any given point of time and with any given set of policies*, there is a level of unemployment below which inflation tends not just to increase but to accelerate, and above which inflation tends not just to decrease, but to decelerate. That appears to be also now a virtually unanimous view among economists. In the United States, economists have estimated that this so-called non-accelerating inflation rate of unemployment, or NAIRU, is somewhere around 6 percent of the labour force. In many of the countries of western Europe, the NAIRU is almost certainly much higher than that, perhaps as high as 10 percent or more in some countries. In New Zealand, we do not use the concept in policy formulation at this stage because we simply do not know what the NAIRU is. What we do know, or at least strongly suspect, is that the NAIRU has been decreasing in New Zealand in recent years, with the increased flexibility of the New Zealand labour market. Few economists would have estimated that the NAIRU was below 7 percent in New Zealand three or four years ago. We almost certainly owe the fall in the NAIRU, and the non-inflationary increase in employment which has taken place in the last few years, to that increased flexibility, while policies which might reduce that flexibility would clearly increase the rate of unemployment consistent with stable inflation. In other words, the NAIRU is in no sense immutable.

For while unemployment is not a function of the rate of inflation, it *is* a function of other policies: of how generous the unemployment benefit is (who can doubt that if, for example, the unemployment benefit were doubled, the unemployment rate would rise?); of the level of the minimum wage (who can doubt that a major increase in the minimum wage would discourage the employment of relatively unskilled workers?); of the level of training enjoyed by, and therefore the productivity of, potential employees (who can doubt that if today's unemployed workers were skilled in, for example, computer software, many of them would be employed?); of the difficulties created by the Employment Court in dismissing workers (who can doubt that the more difficult it becomes to dismiss workers, the more reluctant employers will be to take a chance on hiring new staff?).

As Mr Ted Evans, Secretary of the Australian Treasury, once observed, unemployment is to a significant extent a policy choice. Not a choice about the inflation rate, but a policy choice nonetheless. The East Asian countries with the lowest levels of unemployment (Singapore comes to mind) place enormous emphasis on education and training, have no legislated minimum wages, and have no unemployment benefit. Is it any wonder that they have almost no unemployment? We could choose to have less unemployment, or in other words to lower New Zealand's NAIRU, but it might well involve policies which for other reasons we would prefer not to adopt. It is not my role to advocate such policies. But it *is* appropriate to draw attention to the fact that there is a choice involved, and that it is not a choice about inflation.

Low inflation helps economic performance but does not *guarantee* balance of payments surpluses

And what about the balance of payments deficit? Our *Economic Projections* suggest that, for the year to March 1996, the current account deficit will have been 4.3 percent of GDP, while in the year to March 1998 the deficit could be 5.2 percent. At this level, the deficit is significantly smaller, as a percentage of GDP, than it was in the mid-eighties or the mid-seventies. (Indeed, in the mid-seventies the deficit at one point reached 13 percent of GDP.) But it is a deficit which is both higher than the deficit in recent years and higher than the deficit which most commentators had been forecasting.

The first question which arises is: does the projected deficit matter? I once heard the eminent US economist Milton Friedman say that the world would be a very much happier place if governments did not calculate balance of payments data. He noted that the State of California did not know whether it was in surplus or in deficit on its 'balance of payments' with the rest of the world, but that if it did know, and if it were in deficit, the Governor of the state would feel absolutely obliged to 'do something about it'. Friedman suggested it was much better not to know.

By international standards, moreover, the deficit is not enormous. Singapore, now running a balance of payments surplus of some 18 percent of GDP, ran deficits of more than 10 percent of GDP for some years. Thailand and Malaysia are currently running deficits which exceed 7 percent of GDP. By comparison with some other countries, our deficit is probably somewhat over-stated, including as it does a large volume of profits accruing to, but not remitted to, foreign shareholders. (Indeed, in the latest year it is estimated that roughly half the current account deficit was financed by profits which accrued to foreign shareholders, but which foreign shareholders chose to reinvest in New Zealand. In some countries, profits accruing to foreign owners, but not remitted, are not included in the current account deficit.)

Perhaps the strongest reason for not being too concerned is that, unlike the deficits through most of New Zealand's recent history, the current and projected deficits are the direct result of private sector choice. A current account balance of payments deficit means, by definition, that New Zealanders are choosing to spend more in total, on consumption and investment, than they earn in total. But we know that the government is currently 'earning' more than it is spending (in other words, the public accounts are in surplus). So the current account deficit must mean that the private sector is choosing to spend more than it earns. It is not immediately obvious that policy-makers should try to override that private sector choice.

What role is monetary policy playing in all this? Is tight monetary policy partly to blame for the balance of payments deficit, as some have suggested, by pushing up the exchange rate, thus slowing the growth of exports and encouraging the growth of imports?

There is little doubt that much of the burden of monetary policy restraint over the last two years has been borne by the export sector and by those competing with imports. But why is this? Essentially it reflects the fact that consumer spending has been surprisingly unresponsive to rises in inflation-adjusted interest rates to quite high levels. (Put another way, saving behaviour has been quite unresponsive to rises in inflation-adjusted interest rates.) As a result, a disproportionate share of restraint has had to be borne by the external sector.

Monetary policy does not deliberately hammer the export sector of course: if consumer spending were a lot more sensitive to interest rates than it appears to be, the external sector would not have been hit as hard as it has been.

But easing monetary policy would not solve the balance of payments problem or, for long, the problems of the external sector.

Easing policy would, in the short term, have two conflicting effects on the balance of payments if we assume, as is probably reasonable, that the easing would lead to a reduction in both the exchange rate and interest rates. The lower exchange rate would presumably encourage exports and discourage imports, thus reducing the deficit. But despite the fact that recent increases in interest rates have slowed spending to only a modest extent, there seems little doubt that *reducing* interest rates would stimulate total domestic spending, reducing the goods *available* for export and encouraging the demand for imports, thus increasing the deficit. Little wonder that in many countries it is taken as axiomatic that *tighter* monetary policy is the correct response to a troublesome balance of payments deficit.

Easing policy would help the external sector in the short term because it would lead to a lower exchange rate. But as we have established conclusively over the last 25 years, the higher inflation which would inevitably follow from that easing would, within a year or two, put exporters and those competing with imports right back to square one - with higher inflation offsetting any benefits from the lower exchange rate.

At the end of the day, the balance of payments deficit is an issue about the balance between investment and savings. Recent economic reforms have greatly increased the opportunities for profitable investment in New Zealand. Almost everybody welcomes that increased investment, providing as it does the opportunity for New Zealand to improve productivity and increase total output.

But who is financing this increased investment activity? The government, by running fiscal surpluses, has been helping, as I have already noted. But the New Zealand private sector has not been making up the difference, despite higher inflation-adjusted interest rates. As a result, we have been drawing on the savings of others - running current account balance of payments deficits as the counterpart of the capital inflow. We have a stark choice: accept lower investment activity and lower growth; improve our national saving performance; or continue drawing on the savings of others and accept our continued dependence on foreign investors.

At the moment, we are opting for relatively high levels of investment financed by the savings of foreigners - in other words, we have a current account deficit. The root cause of that is certainly not monetary policy, but rather the reluctance of New Zealanders to save enough to finance available investment opportunities.

Will that continue? In other words, will the New Zealand private sector choose to continue spending more than it earns, and will foreigners continue being willing to finance that spending? In the *Economic Projections*, we indicated that we saw no compelling reason why that process should stop over the period covered by the projections (to March 1998). Private sector balance sheets are clearly incurring more debt, but it is not immediately obvious that this process will cease over the forecast period. Similarly, there is no obvious reason why foreign capital inflow should cease: New Zealand is rightly recognised as having economic fundamentals which are among the best in the OECD, and we are the only country in the OECD which is currently running a genuine budget surplus. There is a growing awareness that a large part of what is officially described as overseas debt is in substance equity investment and not debt (roughly half of the private sector's total foreign debt is represented by debt owed by companies in New Zealand to their overseas affiliates).

The Reserve Bank has no exchange rate 'target'

But as we noted in the *Projections*, it is important to note that this situation *could* change. The willingness of the New Zealand private sector to spend more than it earns, and the willingness of foreign companies and institutions to finance that spending, could both be affected by a loss of confidence in New Zealand's prospects, or improved prospects elsewhere. Increased concern about the balance of payments, for example, could trigger a reluctance to invest in New Zealand on the part of foreigners. Increased concern about political risk could similarly make foreigners reluctant to invest in New Zealand - and indeed could make New Zealanders reluctant to invest also. This loss of confidence would almost certainly be reflected in a lower exchange rate, and reduced demand for the importation of investment goods. The balance of payments deficit would probably reduce quite quickly.

The exchange rate could also fall if, perhaps again because of a loss of confidence, the recently-strong increase in property market prices were to come to an end, or even go into reverse. With inflation in housing-related components of the CPI accounting for approximately half of all underlying inflation in recent quarters, it is not hard to see how a *fall* in property prices would quickly reduce underlying inflation to near the bottom of our target range, and potentially even below the bottom. It would not take financial markets long to realise that, in those circumstances, a fall in the exchange rate would be quite consistent with continuing average price stability.

And this is my final point, and I make it because it never ceases to surprise me how many people, some of whom should certainly know better, still believe that in some way we have an exchange rate 'target'. The Reserve Bank has been charged by Parliament with operating monetary policy to maintain 'stability in the general level of prices', which successive Governments have defined as best characterised by 12-monthly increases in the Consumer Price Index of between 0 and 2 percent, adjusting for the direct effects of interest rates and certain shocks beyond the direct reach of New Zealand monetary policy. We are committed to doing this. This will mean that, from time to time, the New Zealand dollar will appreciate strongly in response to a tightening of monetary policy. It will also tend to mean that, over the long-term, the New Zealand dollar will have a tendency to appreciate gradually, reflecting our inflation rate being rather lower than that in our trading partners.

But this does *not* guarantee that the New Zealand dollar will appreciate at all times, and that the New Zealand dollar is therefore a one-way bet for foreign investors. To begin with, even if the trade-weighted measure of the New Zealand dollar appreciates, it does not follow that the New Zealand dollar will appreciate against any individual currency in the 'basket', a point not overlooked by US-based investors for some months in 1995 when the New Zealand dollar appreciated against the total basket but depreciated somewhat against the US dollar. Furthermore, a sharp reduction in inflationary pressures in the economy, such as occurred for example in 1991, or such as might occur in the future if confidence in ever-increasing property prices were to evaporate, would mean that the overall inflation rate could be kept within the target range despite a fall in the exchange rate, as I have already noted.

The Reserve Bank's so-called 'comfort zone' for the trade-weighted measure of the exchange rate is our own best estimate of the range within which the exchange rate can move and still have the inflation rate between 0 and 2 percent in 12 to 18 months' time, *in the light of all the other factors bearing on the inflation outlook at that time*. The 'comfort zone' changes as the other factors bearing on the inflation outlook change.

We are committed to maintaining average price changes within the 0 to 2 percent range. We are convinced that by doing that we make our best contribution to the performance of the economy. That is likely, over time, to mean that the New Zealand dollar has a tendency to appreciate gradually. But we do not have an exchange rate target, and there will certainly be occasions when the exchange rate will fall.

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