“The road ahead”
A presentation to small and medium-sized businesses

Don Brash, Governor of the Reserve Bank of New Zealand

1 Introduction

Over the years, the Reserve Bank has done a reasonable job in communicating with the banks and large companies in New Zealand. We have done a much less satisfactory job in communicating with smaller companies, not because of any lack of interest in that part of the economy but rather because of the difficulty of *reaching* smaller companies. Today, and at other similar meetings throughout the country, I want to try to go some way towards rectifying that failure.

I want to start off by sketching some of the background, and in particular to outline some of the dangers in the global economy.

Then I want to outline why I am optimistic about the future of the New Zealand economy, notwithstanding the international uncertainties.

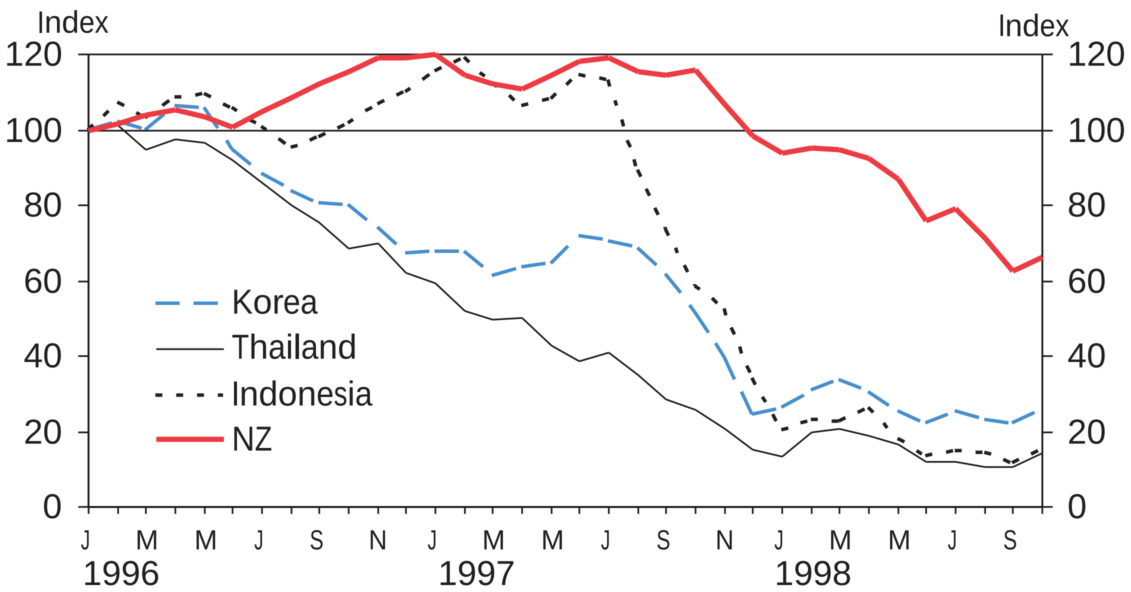
And finally, I intend to make some comments on the role of the Reserve Bank in this situation.

2 The global economy

As most of you will know from media reports, the international economic environment is more uncertain, and more downright unnerving, than for a very long time.

In the middle of last year, Thailand was forced to abandon its previously-pegged exchange rate and devalue its currency. By the end of last year, the currency crisis which had begun in Thailand had spread to Indonesia and South Korea, with large-scale capital flight, heavy loss of foreign exchange reserves, sharp falls in exchange rates, and drastic falls in share prices. Those countries have seen a huge increase in bankruptcies and extreme poverty, and have been grappling with banking crises which make the problems which we faced in the late eighties look totally trivial by comparison. Indonesia has seen a fall in total output reminiscent of the falls experienced by developed countries in the thirties, and Korea is not far behind. The effect on share prices is well illustrated in figure 1.

Figure 1
Equity prices
(Index of US$ value, Jan 1996 = 100)



Japan, the second largest economy in the world, has seen nearly a decade of extremely sluggish growth, and is today enduring a prolonged recession. The Japanese Government has recently passed legislation to assist in the re-capitalisation of the country's banking system, and voted the equivalent of NZD1 trillion for that purpose. Nobody knows whether that enormous sum - one million million New Zealand dollars, or the equivalent of all the output New Zealand will produce over the next ten years - will be sufficient to restore the Japanese banking system to health.

Just a few months ago, the Russian government defaulted on its debt, and threw not only the banking system of that country into further confusion but created unprecedented turbulence in international financial markets. The exchange rates of other emerging markets were put under great strain; one of the largest US hedge funds came to the brink of collapse (after losing virtually all of its USD4 billion in equity); the US dollar fell against the Japanese yen by more in two days than in any other two-day period since floating currencies began in 1973; and large numbers of companies in the US found themselves quite unable to borrow in the capital market.

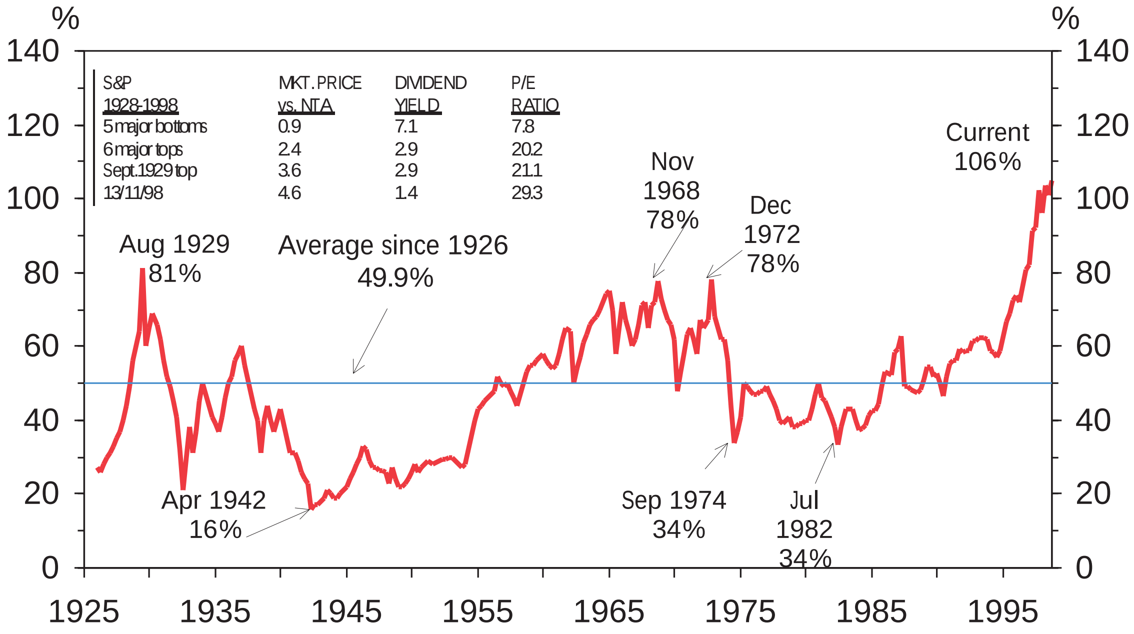
Business confidence in the United Kingdom has recently fallen to its lowest level since 1980, while one of the largest banks in the United States estimates that that country will be in recession next year.

And looming over all is the possibility of a large 'correction' in US, and therefore in global, share prices. At mid-November levels, the S & P 500 index of US share prices valued the shares in that index at over 100 percent of US GDP, compared with a comparable figure of 81 percent at the market peak in 1929. At the same time, the dividend yield on the shares in the S & P 500 index was, at 1.4 percent, slightly under half that at the market peak in 1929. Many observers regard the US share market as considerably over-valued at present levels.

Addressing the National Association for Business Economics in early October, Alan Greenspan, the chairman of the US Federal Reserve Board, said that at no time since he first became a professional economist as a young man in 1948 had he seen a situation quite like it.

In recent weeks, the position in financial markets appears to have stabilised somewhat, and many people, Mr Greenspan

Figure 2
Market value of the S&P 500 Companies as a percentage of US GDP



Sources: Marc Faber Ltd, Pacific Alliance included, are feeling rather more relaxed about the outlook. Most observers still see positive growth in the United States, Europe and Australia next year. In several of the crisis countries of Asia there have been impressive steps taken to restore economic health. But the risks in the international economic environment clearly continue to be substantial.

3 Implications for New Zealand

It would be astonishing if this turbulent and threatening world environment had had no impact on the New Zealand economy, and of course there has been impact aplenty.

On the positive side, we have seen the price of some of our major imports decline. The price of crude oil, for example, has fallen from around USD23 per barrel in early 1997 to around USD12 per barrel in mid-November this year, a reduction in US dollar terms of nearly 50 percent. There have been various reasons for this, but one important reason is the weak world economy.

But that weak world economy has had plenty of adverse effects. Just as the US dollar price of imported oil has gone down, so also has the price of many of the major commodities which we export, such as lamb, logs, and aluminium. Overall, the ANZ Bank index of New Zealand commodity prices declined by 12 percent (in world price terms) between early 1997 and September 1998. For a number of months earlier this year, exports of logs came to a virtual halt, while the number of visitors from Korea, one of our most important tourist markets, fell by some 90 percent. I certainly do not need to remind those in our forest product industry, or in our tourist industry, about the impact of the global slowdown on their operations. With six of our 10 largest export markets in East Asia in 1997, it is no surprise at all that the sharp deterioration in the economic fortunes of many of the countries in that region has had a severe impact on New Zealand.

Plenty of people have become very worried about the outlook for the New Zealand economy, and I am often asked why there seems to be 'no plan' to deal with the situation. In a fundamental sense, successive New Zealand Governments began preparing for this situation nearly 15 years ago with policies to systematically improve the resilience and flexibility of the economy. This is not the place to describe all of those policies, most of which will in any case be familiar to you, but let me speak to just a few of our important advantages at this time.

First, in recent years there has been a systematic attempt made to reduce the extent to which government over-spends its tax revenue, in other words to reduce the fiscal deficit, and in this way to reduce the size of the government debt relative to the size of the economy. For the last five years, the government Budget has been in surplus, and New Zealand is one of only a tiny handful of countries which can make that claim. And these have been genuine surpluses, with revenues exceeding expenditure, not surpluses dependent on asset sales. Largely as a consequence (though helped to a small extent by asset sales also), the ratio of government debt to GDP has fallen from over 50 percent in the early nineties to around 25 percent now. This is not the lowest ratio of government debt to GDP in the developed world - Australia's ratio is lower than ours, and Singapore's is much lower still (indeed Singapore has no net public sector debt). But it is nevertheless a debt level which is very much lower than that in most other countries, and it puts the country in a good position to handle any adverse events which hit us from overseas.

Secondly, thanks in part to policies which allow new banks to operate in New Zealand, whatever their nationality, we have a banking system today which is intensely competitive, and as sound as at any time in my memory. Of course, having a sound banking system does not make us unique, but it does make us distinct from almost all of the countries which are now experiencing severe economic difficulties. Indeed, the distinctive characteristic of all the Asian economies which have serious difficulties at the present time, Japan included, is a very serious banking problem. Banks which have incurred huge loan losses, and which have lost all, and sometimes much more than all, of their shareholders' funds, are in no position to provide the credit which a growing economy needs. Fortunately, New Zealand is not in that situation, and I am advised that banks in New Zealand remain able and willing to lend on creditworthy projects.

Thirdly, in March 1985 the New Zealand dollar was floated and the Reserve Bank has not intervened in the foreign exchange market since that time. In other words, we have a clean float. Not everybody sees that as an unmixed blessing, but in my view the policy has had two very important benefits.

First, it has meant that, as views about the risks of holding New Zealand dollar assets change, the value of the currency changes, without any political or bureaucratic intervention, indeed without any need for political or bureaucratic decision. Thus, over the last 21 months, as New Zealand's balance of payments deficit became a worry to financial markets, and concern about the impact of the Asian situation on our exports became more widespread, the international value of the New Zealand dollar fell, by around 18 percent on a trade-weighted basis, thus providing some assistance to our exporters and those competing against imports. Nobody had to wait until the Treasurer, or the Governor of the Reserve Bank, recognised the need for a change. Nobody had to ask taxpayers to pay for the consequences of political judgements about the appropriate level, or the appropriate rate of change, of the exchange rate.

Second, the fact that everybody has known that the exchange rate was floating has strongly discouraged banks and other companies from borrowing money overseas without taking appropriate forward exchange cover. Sadly, it seems that in virtually all countries which have had pegged exchange rates, banks and companies have borrowed overseas in foreign currencies without hedging the exchange rate risk, and have as a result suffered huge losses when (and I say 'when' rather than 'if' since I know of almost no pegged exchange rates which have lasted much more than a decade) those pegged exchange rates came 'unpegged'. Yes, there were companies which suffered losses with the depreciation of the New Zealand dollar over the last 18 months, but, although I am sure those losses were painful, in very few cases have they proved fatal. Indeed, a great many companies have welcomed the lower exchange rate. The situation in Thailand, Indonesia, and Korea has been very different.

Of course, I do not want to pretend that having a floating exchange rate can protect New Zealand from adverse events abroad. Those shocks still hurt. But the floating exchange rate spreads the burden of adjusting to those shocks around the economy. It also enables us to choose both our own inflation rate and our own monetary policy.

So in summary, those who ask why nobody is coming up with a plan to protect New Zealand from the Asian crisis are asking the wrong question. New Zealand already has a plan. It was set in the mid-eighties, when we as a nation set about reforming our economy to be more flexible, more open, and more adaptable. In effect we decided that rapidly adapting to international shocks was better than trying to pretend we could resist or avoid them. That was the judgement we made, remembering that throughout most of our history vulnerability to changing terms of trade has been the dominant story of the New Zealand economy. The evidence so far is that that judgement was right.

4 The role of the Reserve Bank

Let me turn now and speak a little about the role of the Reserve Bank in this situation. Are we part of the problem or part of the solution? Framing the question like that perhaps gives the game away: you would be surprised indeed if I were to argue that we are part of the problem! But more than that, I want to argue that the Bank, and the framework within which we are required to operate by law, make an important contribution to New Zealand's ability to weather adverse events, including the present international storm.

But first, a couple of disclaimers. The first is an acknowledgement that monetary policy has only a relatively small effect on the economy's *long* term potential growth rate. To be sure, by keeping inflation low monetary policy can minimise the costs, distortions and resource misallocation which often accompany *high* inflation. I believe that it is reasonable to claim that, at the margin, this reduction in costs and improvement in resource allocation assists the economy to grow at a faster rate than would otherwise be the case. Over long periods of time, this small improvement in the economy's potential growth rate is undoubtedly worth having. But the main things determining our potential growth are things like how good our education system is, how well we invest our savings, how government policies affect incentives to acquire skills, how efficiently the public sector uses resources, how good our managers are, how fast the labour force grows, and a great many other factors. Monetary policy helps, but can not single-handedly convert a slow-growth economy to a fast-growth economy.

The second point to acknowledge is that, no matter how good the Reserve Bank is at forecasting the economy, no matter how good our models and crystal balls are, neither we nor any other central bank can eliminate the business cycle. The time delays between monetary policy action and the impact of that action on the real economy are too long, and too uncertain, to make any pretence that we can achieve such an ambitious objective. There will continue to be periods of above-trend growth, and there will continue to be periods of below-trend growth, and occasionally of recession. Monetary policy will never be able to shield a New Zealand log exporter from the adverse effect of his Korean customer becoming bankrupt, nor will monetary policy ever be able to protect a farmer hit by a severe drought, or an orchardist hit by an untimely frost.

Moreover, even with some 14 years' experience of operating monetary policy with the primary objective of keeping inflation under tight control, there is much we do not understand about how the economy works, and perhaps never will. For example, why, during the mid-nineties, were we New Zealanders so enthusiastic about borrowing at interest rates which, when measured against inflation in the CPI, were amongst the highest in the developed world? That willingness was clearly a major headache at that time, in that it required monetary policy to be much tighter than might otherwise have been the case, which in turn caused the exchange rate to appreciate strongly and put very considerable pressure on exporters and those competing with imports.

So those are important points to note. Monetary policy can assist New Zealand's long term growth rate at the margin, but can't convert a slow-growth economy into a fast-growth economy. And the Reserve Bank can not abolish the business cycle. Moreover, we will occasionally set policy in ways which, with the benefit of hindsight, turn out to be incorrect.

Having said that, I contend strongly that the *framework* within which monetary policy operates makes an important contribution to the way in which the New Zealand economy handles adverse shocks like the one hitting us from abroad at the present time.

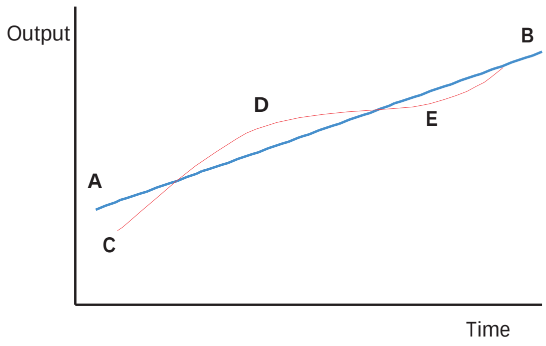
As most of you know, since the mid-eighties the Government has instructed the Reserve Bank to use monetary policy - in other words, to use its ability to influence short-term interest rates and, indirectly, the exchange rate - to achieve one goal and to achieve one goal only, namely stable prices. Since 1989, that single goal of monetary policy has been embodied in legislation, the Reserve Bank of New Zealand Act 1989. And we do that because, as implied a moment ago, it is now the almost unanimous view of economists and economic policy-makers here and abroad that, in the long term, the best and only thing which monetary policy can do to assist economic growth and employment is to keep inflation very low.

But, it is sometimes argued, surely the central bank should have some regard for growth and employment in the *short* term, since clearly even if there is no trade-off between growth and employment on the one hand and inflation on the other in the *long* term, there *is* such a trade-off in the short term. Indeed there is, and the framework within which we operate recognises that.

In fact, once low inflation is achieved, it may be very difficult to detect, by looking at the *behaviour* of a central bank, whether the central bank is exclusively focused on keeping inflation under control or whether it is also taking into account the desirability of keeping growth and employment on an even keel. Why? Because when demand for the goods and services which an economy produces is below the output which the economy can produce on a sustainable basis, inflation will tend to fall, and to keep falling for as long as demand stays below sustainable capacity. And when demand is above what the economy can produce on a sustainable basis, inflation will tend to rise, and to keep rising for as long as demand stays above sustainable capacity.

Let me repeat this point, because it is extremely important. Because inflation tends to rise, and to keep rising, when demand exceeds the economy's sustainable capacity to produce goods and services, and to fall, and to keep falling, when demand falls short of the economy's sustainable capacity, a monetary policy focused exclusively on keeping inflation low and stable has the important by-product of taking account of what is happening to output and employment also. It is therefore quite misleading to suggest that focusing monetary policy on inflation alone in some way ignores what is happening to the real economy.

The point can be readily seen by looking at figure 3.



The line AB represents the growth in output which the economy can potentially sustain over the long term. The slope of the line, or in other words the economy's long term rate of growth, is driven mainly by the real factors I mentioned earlier, namely the quality of the education system, how wisely we invest our savings, how government policies affect incentives to work and acquire skills, and so on. Monetary policy helps in that, by keeping inflation low, it helps to avoid resource misallocation and other distortions, so that the economy has a somewhat faster potential growth rate than would be the case with high inflation.

The curved line CDE represents the actual output of the economy. When the economy is producing below potential, as at points C and E, inflation is likely to be falling towards the bottom of the inflation target, and monetary policy will be relatively easy. When demand exceeds the economy's potential, as at point D, inflation is likely to be rising towards the top of the inflation target, and monetary policy will be relatively tight. In focusing on inflation, monetary policy also tends to keep demand moving towards the economy's sustainable output.

Through much of the mid-nineties, monetary policy was relatively tight because at that time demand was tending to exceed the economy's sustainable capacity, and the fact that inflation was pushing up to, and indeed through, the top of our inflation target (then 0 to 2 percent) was ample evidence of that. (In terms of figure 3, New Zealand was at point D.)

In late 1996, despite inflation still being somewhat above the top of our inflation target and nobody expecting either the Asian crisis or the drought, we began to ease monetary policy because we were projecting a period of slower growth, with demand dropping below the economy's capacity and inflation falling. As time went by, and the Asian crisis and the drought hit, we eased more aggressively. It is of course possible to debate whether we were too fast or too slow in doing that, but my point is simply that, as demand was seen falling well below the economy's capacity, we eased more and more aggressively, so that by mid-November the exchange rate was down some 18 percent on a trade-weighted basis from its peak in early 1997, and interest rates were reduced to their lowest levels in years. (In terms of figure 3, we are now at point E.)

A few weeks ago, I saw a share-market commentary which, after expressing concern that perhaps the Reserve Bank still had monetary policy too tight, perhaps for the sake of protecting my job, suggested that it was time for New Zealand to have a *minimum* inflation target as well as a maximum. I admit I was dumb-founded by this. It is a sad reflection on the Bank's public communications that there are still people out there - and people holding themselves out as well-informed financial advisers - who do not yet know that we have *always* had a minimum inflation target as well as a maximum one. And the Reserve Bank takes *both* sides of its inflation target, both the 3 percent maximum and the zero minimum, equally seriously. When demand looks like exceeding the economy's capacity, we can be relied upon to tighten policy. When demand looks like falling short of the economy's capacity, we can be relied upon to ease policy.

If we had not tightened policy in early 1994, we would certainly have seen much more inflation than we in fact saw in 1995 and 1996. To be sure, the exchange rate might not have increased as strongly as it did, but with faster increases in domestic costs it is not at all obvious that exporters would have been any better off. One way or another, when inflation starts going up in the domestic economy, exporters (and those competing with imports) get squeezed. If monetary policy *is* tightened to head off the inflation, the exchange rate tends to rise and the New Zealand dollar revenue which exporters derive from their foreign sales goes down. If monetary policy is *not* tightened, and inflation increases, then exporters are not pressured by the rising exchange rate, but rather by rising domestic costs. Worse, if monetary policy is not tightened, the risk is that inflationary pressures spill into inflationary expectations and asset prices. Indeed, we saw a mild version of that with increases in house prices and some farm land prices in the mid-nineties. But if policy had not been tightened, there can be little doubt that inflationary expectations and asset prices would have increased still more sharply, and we would now be nursing the kind of hangover which many of the Asian economies are experiencing, with huge post-bubble falls in asset prices.

Similarly, if we had not eased policy throughout 1997 and 1998, there is not the slightest doubt in my mind that inflation today would be below the bottom of our inflation target. And, as indicated, we are as determined to avoid that as we are to avoid going through the top of the target. Indeed, since we first entered the inflation target range agreed with Government, inflation has at no stage gone through the bottom of the target range, and in fact it has never even been in the *bottom half* of the target range. Of course, the day may come when inflation (as measured by the CPI excluding interest rates, or CPIX) does fall below zero, just as it went through the top of the target range in 1996 (and briefly in 1995). But we will be working hard to avoid that outcome, in exactly the same way that we worked hard to avoid breaching the top of the range.

When the Reserve Bank Act was passed in 1989, the inflation-targeting regime which that legislation established was unique in the world. Today, it has become entirely orthodox, with Australia, the United Kingdom, Canada, Sweden and other countries having regimes which are closely similar. Most recently, the European Central Bank has adopted an approach which has many similarities, with the Governing Council of the Bank making it clear that the ECB will aim to keep inflation below 2 percent annually.

That inflation targeting is as appropriate for times when inflationary pressures are weak as it is when inflationary pressures are strong was well illustrated by Sweden during the Great Depression of the thirties. At that time, the Swedish central bank became the first central bank in the world to aim quite explicitly to use monetary policy for the purpose of keeping a stable price level. At that time, of course, the danger was that the depression would cause the price level in Sweden to fall. By operating policy with the explicit objective of trying to avoid Sweden's price level falling, the Swedish central bank was not able to prevent some fall in Sweden's price level, nor to prevent some fall in Sweden's employment, nor to prevent some fall in Sweden's GDP. But on all three measures Sweden's experience in the thirties was substantially less painful than was the case in, for example, the United States.

If New Zealand were hit with further bad economic news from overseas, no amount of good monetary policy could prevent that being painful to many people and businesses. But monetary policy targeted at keeping inflation both above 0 and below 3 percent would materially assist us in dealing with the pain.

So in conclusion, the New Zealand economy, as it is structured now, bends in the wind rather than breaking. As the Asian crisis and the drought have hit, so the exchange rate and interest rates have fallen to help the economy get back into growth. This has occurred without drama, panic or any kind of speculative or national crisis. The markets and the Reserve Bank have not ended up in a tug of war, and in that sense the system has worked well. In the months ahead, the benefits in terms of recovery will be there to see.