Living with low inflation: farming for profit

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Introduction

Thank you very much for that kind welcome.

I must, however, immediately ask your forgiveness in that I am going to change the topic of my address from that which is printed in the very elegant programme which you have before you. When I came to prepare this address I went back to the title suggested for me – "Business performance and investment; redefining the industry" – and I could see the thrust of what was being asked for, but my heart dropped.

You see, I could regale you with old war stories about when I tried to assist in the marketing of kiwifruit. I could give you my frank assessment of the performance of the producer board with which I have most personal contact, the Kiwifruit Marketing Board, or whatever it is now called. I could tell you I am still successfully losing money as an absentee kiwifruit grower. I could talk about added-value. I could chant the mantras – which you all know – saying there's no future in selling undifferentiated commodities. I could say we all need to be in the business of building top-of-the-line brands. I could claim that, if we did that, then, regardless of the exchange rate or the state of the world economy, all would be well. I could say the rich and the famous would then want to buy our products – top-of-the-line, nuclear-free, greener-than-green, designer foodstuffs and natural fibres, all sanctioned by Xena the Warrior Princess and Peter Blake.

I could say all that, and it would all be true, but from me it would just be rhetoric in that I am not in the marketing business, except perhaps of price stability. As a central banker, I think I should talk about the things I know best, under the title "Living with low inflation: farming for profit".

Moreover, I suspect that what I'm going to say is germane to what this summit is trying to achieve.

The exchange rate

In the last two or three years, the Reserve Bank has been acutely aware that its policies have been causing, or appearing to cause, the nation's export farmers a whole lot of distress. Often, in despair, farmers would tell us that the rising dollar was driving them into the ground, and for some it was. Between the low point in early 1993 and the high point in early 1997, the New Zealand dollar rose against the US dollar by nearly 40 percent, while even on a trade-weighted basis the increase was some 30 percent, big increases by any standards.

Having acknowledged that, I must also say that sometimes farmers, and unfortunately some of their representatives, blamed the exchange rate when the real villain was low world prices over which monetary policy could have no influence. As I have noted on other occasions, for example, roughly three-quarters of the fall in the farm-gate price of bull-beef over the three years to June 1996 was a result of the fall in US beef prices, with only one-quarter of the fall explained by the rise in the New Zealand dollar. Moreover, while I would not deny for a moment that the rise in the exchange rate between early 1993 and early 1997 put huge pressure on many farmers, it is important to recall, for what I am going to say in a moment, that that rise had at least some offsetting advantages: the price of fuel was lower than it would have been otherwise, as was the price of tractors, the cost of off-farm transport, and quite probably the cost of farm and off-farm labour as well. I've sometimes felt that, for some marketing agencies at least, the Reserve Bank has been a convenient whipping boy, or a way to pass the buck – pardon the pun.

Now export farmers are feeling much better, or at least those who have escaped the impact of the drought are feeling better. The exchange rate has fallen sharply, and some observers feel it will fall further yet. Hopefully, as a result, the New Zealand dollar incomes of export farmers will rise. I'm sure many farmers are now saying it's time to reinvest in their farms. If that's the case, I'm delighted.

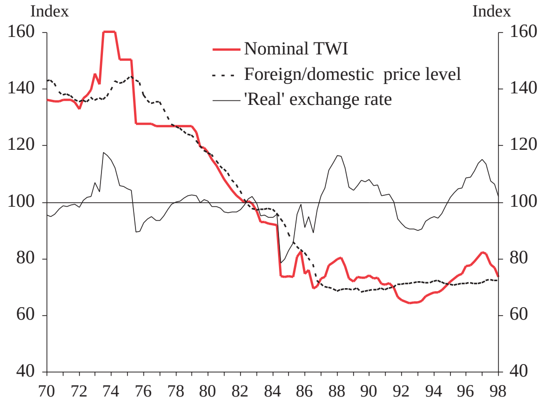
But I want to sound a warning note to farmers. Yes, everything else being equal, your end of the court is now favoured, just as it was back in the early 90s. But it is important to remember that exchange rates go both up and down, and you should not assume that, just because the kiwi dollar has fallen sharply over the last six to nine months it will stay down at these levels permanently. Indeed, if our economy prospers, we should expect to see a gradual appreciation of the exchange rate over the long term.

Perhaps farmers need to think about the exchange rate the way Canterbury farmers think about rain. Sooner or later, droughts are going to happen.

Consider what we call 'the real exchange rate'. The real exchange rate is New Zealand's nominal exchange rate, adjusted by the difference between inflation in New Zealand and inflation in our trading partners. This is more relevant to exporters than simply looking at the nominal exchange rate: clearly, if inflation within New Zealand is markedly higher than that in our trading partners, even a falling exchange rate is of little help to exporters, while if our inflation is markedly lower than that in our trading partners, exporters can cope with an appreciating exchange rate. When the real exchange rate rises, or in other words when the nominal exchange rate rises by more than the difference between our inflation rate and that of our trading partners, exporters are put under real pressure. And vice versa. Now have a look at graph 1.

The solid line is the nominal Trade Weighted Index, in other words the nominal exchange rate. The dotted line shows the difference between inflation in New Zealand and inflation in our trading partners. As you can see, over long periods of time, the nominal exchange rate tends to reflect the difference between our inflation rate and that of our trading partners: when our inflation was relatively high, our exchange rate tended to depreciate; when our inflation was relatively low, our exchange rate tended to appreciate.

Graph 1
Nominal and 'real' trade weighted exchange rate
(1970 - March 1998 average equals 100)



Of course, there have been divergences between the two lines, sometimes for periods of three or four years at a time, and that is illustrated by the dashed line, or real exchange rate. But over the whole period shown, nearly 30 years, there has been no persistent tendency for the real exchange rate to rise or fall, and that is true despite the fact that through the first half of the period the exchange rate was essentially pegged to the US dollar (with periodic devaluations) while for the last 13 years the currency has been floating. The dashed line – the real exchange rate – has fluctuated around a pretty flat trend-line. Back in the late eighties, farmers were in despair, and part of the reason for that was that the real exchange rate was at a peak in 1987/88. In the early nineties, by contrast, it was relatively low, and farmers were feeling much better. In the mid nineties, it was up again, and now its coming down again. Note how enduring this cycle is, irrespective of the exchange rate regime. Farmers need to remember this when judging what investments are worthwhile.

A good Canterbury farmer knows that droughts are inevitable, and plans accordingly. Likewise, a good exporter knows that fluctuations in the real exchange rate are also inevitable, and plans accordingly. I would like to be able to say that the Reserve Bank can reduce the amplitude of these fluctuations, but since fluctuations in the real exchange rate have been of broadly similar magnitude in, for example, the United States, Japan, Australia and the United Kingdom in recent years, I can give you no confidence at all in this regard.

Interest rates

My staff tell me that 12 months back they were often fielding calls from angry farmers wanting to vent their spleen about the exchange rate. Those calls have dried up. Now the calls of distress are often coming from Auckland – people upset that interest rates aren't lower. A few days ago an Auckland talk-back host was telling me, in no uncertain terms, what he thought about me and monetary policy because he couldn't sell his house. Out in the vast hinterlands of Auckland talk-back radio, I'm becoming a bit of a villain again. I'm consoled by the comment of a wise American central banker who once said that an unpopular central bank governor is not necessarily a good central bank governor, but a popular central bank governor is almost certainly a bad one.

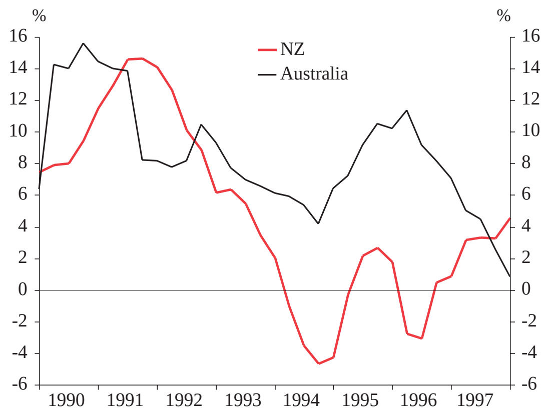
So maybe farmers are a bit happier, for a while at least. However, too often, I'm afraid, farmers do have something in common with that Auckland talk-back host. And this leads me to the amended title of my address. At the beginning of this year my staff and I were wrestling with that old faithful: "Why does New Zealand have such high interest rates relative to other countries?" Now the conventional explanation is: "The New Zealand economy has been more buoyant than others, pushed along by a fiscal loosening, strong immigration and so on. As a result, until recently we had to have monetary policy tighter than elsewhere and that meant higher interest rates than elsewhere."

That is fine as an explanation, as far as it goes. But a key part of the story has also been that insatiable desire to borrow that still afflicts we New Zealanders, so that, as soon as money is available at under 10 percent, we rush down to the bank saying: "Give us more", forcing the Reserve Bank to tighten monetary conditions to contain inflation.

Why is that? Are New Zealanders irrational? I doubt that. But hold on – we've had price stability since 1991. Yet, clearly, if you look at our willingness to borrow ever-increasing amounts at apparently high rates of interest, it's taking a long time for that lesson to sink in, and in the meantime, monetary policy has had to be pretty tight. What's been happening?

Well, one young economist in our Economics Department recently came up with an interesting graph. She compared our real estate inflation with Australia's. She then offset that against the mortgage rates in the two countries and something very telling emerged. People don't borrow to buy the basket of goods and services that go into the Consumers Price Index. Mostly they borrow to buy property. Measured against property inflation, our real interest rates have been much lower than theirs, at least until recently (graph 2). That's to say,

Graph 2
Real mortgage interest rate
(Mortgage interest rate less ex-post house price inflation)



our mortgage rate minus our residential property inflation has, until recently, been much lower than Australia's mortgage rate minus their property inflation. So, in the mid nineties, it made more sense to borrow to the hilt to buy property in New Zealand than in Australia. New Zealanders weren't being irrational. They were reacting perfectly sensibly to the incentives that property inflation was giving them, though, I have to add, it has come to an end now, and I fear there may be tears, as happens whenever a fall in property prices affects people who have borrowed heavily in the expectation that prices will continue to rise indefinitely.

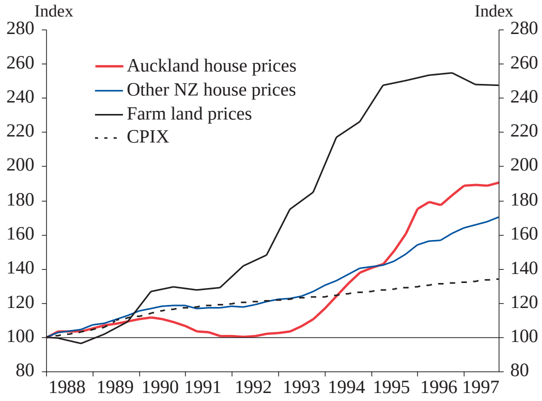
Living with low inflation

Let's peel this back further. Why did property inflation continue in the nineties? We achieved price stability measured by the CPI in 1991. Those representing both sides of wage negotiations quickly understood what that meant. I well recall Ken Douglas saying – and I hope Ken will forgive me if I report this a bit roughly – that he didn't support this new Reserve Bank obsession with price stability, but if that was going to be the fact of the matter, then double digit pay rises were a thing of the past. Likewise, retailers and the providers of services quickly surrendered the traditional cost-plus attitude of the seventies and early eighties.

However, strangely, we have been far less successful with property ownership, and, I have to say, this applies both in town and in the countryside, as graph 3 illustrates: for most of the last decade, both house prices and farm prices have risen markedly more quickly than the general rate of CPI inflation. Far too many people still see getting heavily into debt to buy a second property as the best way they can save for their retirement, even though, in my view, they will be disappointed.

Lest I be misquoted yet again, I'm not criticising home ownership. Owning your own place is normally a good thing to do because it provides a secure home. It also provides an asset for people, particularly in their retirement, assuming it is financed rationally. I own a home myself, and have done so for most of my adult life, for all the normal reasons that apply to most New Zealanders. However, my concern is that – forgive me pinching a great line – New Zealanders' 'irrational exuberance' for getting into debt, in the hope of making money out of now

Graph 3
House prices and rural land prices
(indexes rebased to a March 1988 value of 100)



non-existent inflation, is still distorting the New Zealand economy.

So, the question remains, why that passion for debt to finance speculative real estate? Why have people, when it comes to their personal finances, failed to learn the lessons of low inflation that they have learnt very well indeed in the work place?

One of my staff has come up with an interesting proposition. He says it's all the Reserve Bank's fault. Maybe we've sold the message wrongly. Maybe our advocacy has been at fault.

Certainly, I've given innumerable speeches about the worth of price stability, but always as a public good or as a benefit that applies to society as a whole. I've talked about how economies perform better if people making investments have a stable currency by which to measure the value of commercial decisions over time. I've talked about social justice, and the way inflation harms the poor and benefits the rich, and so on. Maybe what we, the Reserve Bank, have failed to do is talk about the value of price stability as a private good. More specifically, maybe we've failed to take the lead in saying: "All right, low inflation is here to stay. This is what you need to think about in personally managing your affairs given that fact."

As we bounced this idea about, another staff member said: "Yes, just this weekend, my father – he's got a few properties – said: 'Back when there was inflation I knew how to make money – but now I don't'." At the moment we are investigating some media strategies to start talking about this. I don't know if anything will come of it, but I do think there is an important point here. The virtue of price stability as a private good is a case that hasn't been won yet, or at very least we have failed to explain the implications of low inflation at the individual level.

For example, people need to think about questions like: "Does that second property make sense if, over time, its value will increase at little more than the average rate of inflation, indeed for some properties at less than the average rate of inflation? Given the extent to which property prices have risen faster than incomes over the last few years, is there a risk of a substantial fall in property prices over the next few years? Would I be better investing in financial assets that earn interest? Does putting that deck on the house make sense given low inflation, or will I be over-capitalised? This mortgage is stretching my finances to the limit, so can I endure it, given that my debt won't be wiped out by inflation in five years' time?"

Am I just seeking to re-educate townies doing up old villas in Grey Lynn, not because they want to live in them, but because they plan to sell next year? Well, no. When farmers were in distress about non-tradable inflation and the 'blunt instrument of monetary policy', I, and one or two others on the receiving end, said: "Hold on, what about the runaway prices for farm land? They've been going up just as fast or faster that property in town." "Not fair," replied various farmers' representatives. "That's a cost of production we have to face, not a price we control," they said.

Well maybe. But for the most part farmers sell land to and buy land from other farmers. It seems to me that many farmers are like people in the cities when it comes to their private finances. Too many still haven't internalised the lesson that, by hook or by crook, price stability is here to stay. This is part of why, to put it bluntly, the price of farm land is still very high – certainly irrationally high, if one is assessing the business of farming in terms of the annual profits being earned on the investment. The Meat and Wool Board's Economic Service reports that the rate of return on the market value of farm assets used in farming sheep and beef averaged just 0.8 percent in 1995/96, and 1.7 percent in 1996/97. Indeed, that rate of return has not reached 6 per cent in any year since 1979/80. And this in an industry where the trend of world market prices has been inexorably downwards since the Second World War. Why, on that basis, would anybody invest in farming?

Of course, the answer, in part, is that farming people have non-commercial reasons for wanting to be in this business, as well as commercial reasons, and that's perfectly legitimate. Lots of other people make similar decisions. I recognise also that, in part, the reasons for the low rates of return on sheep and beef properties in the years cited were related to temporary factors, such as the strong demand for land suitable for planting in forestry and, on the other end of the spectrum, for land suitable for conversion to dairying. However, also, I suspect that too many farmers are still farming for capital gain. Too many farmers still think, okay, my life will be pretty basic during my working career, but the life-style is good, and I will have a gold-plated retirement when I sell.

Here I come right back to the wider theme of this summit. I don't think farming for capital gain does farming any good at all. I think it is based on delusion, in that from here on the capital gains won't be there, because inflation has been contained even for farm land prices (indeed, graph 3 indicates as much over the last couple of years, while many observers are predicting some fall in land prices from current levels). However, in the meantime, the entry costs of getting into farming are still too high, which excludes fresh blood and innovation.

For example, why would anybody take seriously advice to improve the market acceptability of the meat they produce, or the wool they produce, if the real crop is selling the property to the next guy? Why would the pursuit of excellence, that this summit is promoting, have any relevance, if the primary goal is property speculation?

The answer, ladies and gentlemen, is no reason at all.

My worry is that, as the profitability of producing meat, and wool, and milk is gradually restored with a lower exchange rate, farmers will quickly capitalise that increased profitability into the price of land once more. If that happens, the profitability of farming will remain low indefinitely: farm-owners may have substantial wealth, but the rate of return on that wealth will remain very low. Eventually, this process only ends when people refuse to invest in an industry where the rate of return is so low and the risks – of weather, disease, and markets – are so considerable, and put their money in the bank instead. Farming doesn't come to an end at that point: land prices fall to the point where the rate of return on farming seems attractive relative to the risk.