Monetary policy in a dangerous world

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Introduction

Over recent months, there has been a great deal of negative economic news. In countries as diverse as Italy and Japan, GDP data for the March quarter have been released suggesting economic activity is slowing down. Growth in industrial production in the 14 countries which we monitor most closely in preparing our own economic forecasts was projected to be just 0.1 percent in 1998 in the June *Consensus Forecasts*, a significant fall from the increase of 3.8 percent expected last November, and even a fall from the 1.0 percent increase expected as recently as last month. Financial markets have been extremely turbulent, with particularly volatile trading in the foreign exchange market and some equity markets. Where is the world economy going, and how will New Zealand be affected?

It is always risky being too definitive in answer to questions of this kind because in reality nobody can know the answers with any confidence. But it is particularly dangerous to give answers at this time. If one suggests that the world economy is in for a very rough ride, and New Zealand with it, one is accused of undermining confidence and making the situation worse. If one points out some of the positive aspects of New Zealand's situation, one is accused of being hopelessly unrealistic.

Today I will try to be totally realistic. You may not agree with me, but I will not gild the lily.

The implications of the situation in Asia are serious for New Zealand

In our December 1997 *Monetary Policy Statement*, we estimated that growth in our trading partners would average 1 percent less than otherwise over 1998/99 due to the events in Asia, and in releasing that document I commented that the most obvious risk to our economic projection was that the difficulties in Asia would turn out to be even more serious than we assumed at that time.

In the intervening six months, the situation has indeed become markedly worse. Whereas in November 1997, the *Consensus Forecasts* projected Japan's industrial production to grow by 1.6 percent in 1998, the comparable estimate in June 1998 is minus 4.0 percent. Whereas in November 1997, the *Consensus Forecasts* projected Korea's industrial production to grow by 8.2 percent in 1998, the comparable estimate in June 1998 is minus 7.8 percent. Whereas in November 1997, the *Consensus Forecasts* projected Indonesia's industrial production to grow by 6.9 percent in 1998, the comparable estimate in June 1998 is minus 13.3 percent. Japan's banking system is under severe strain, and this is hampering the recovery of that economy. The same is true in many of the other countries of Asia. A number – potentially a large number – of banks will fail unless the governments of the countries concerned are willing and able to support them. Even those countries which have strong banking systems, such as Hong Kong and Singapore, face very sharp slowdowns in economic activity and possibly recession in 1998. So the economic situation in Asia has deteriorated significantly in recent months and could get much worse yet.

With the exception of Japan, Korea and Australia, New Zealand has a bigger exposure to Asian markets than does any other OECD country. In 1997, some 36 percent of our total exports went to the countries of East Asia. In that year, Japan was our second largest export market, and Korea our fifth largest market. Of our 10 largest export markets, six were in the East Asian area last year, or seven if Australia is included. And Australia itself has a huge exposure to the markets of Asia, which means that we have a further indirect exposure to those markets through that country, now easily our largest single market. Of the tourists who visited New Zealand in 1997, over 30 percent came from East Asia.

This substantial involvement in the markets of Asia has been of great benefit to New Zealand in the past, and will be of great benefit to us in the future. But right now, their pain is also our headache. In the three months to April, for example, our exports to Korea were down 48 percent compared with the same three months in 1997, while exports to Indonesia were down 69 percent. Some commodity exports, such as logs and deer velvet, have been particularly hard hit. This has had a severe impact on some industries and some regions.

Moreover, there are other risks. If the Japanese economy moves deeper into recession, and the Japanese yen resumes its fall, there could be further downward pressure on other currencies in the region, as well as political pressures to build protectionist barriers around other markets. Or, because of Asian difficulties or for some other reason, the US equity market could turn down sharply, triggering an abrupt slowdown in the United States economy. As I said in releasing our May *Monetary Policy Statement*, it is not at all difficult to envisage circumstances where the New Zealand economy grows more slowly than projected. Indeed, it is possible to imagine scenarios where the *world* economy at least is quite weak. The external environment is not good, and could get markedly worse.

To complicate matters still further, New Zealand enters this period of international turbulence with a balance of payments deficit exceeding 7 percent of GDP, and a negative net international investment position (overseas assets less liabilities to foreigners) of some 80 percent of GDP, both high figures by international standards.

But we have many strengths

So we face serious challenges. But, having established that I am fully aware of that fact, allow me also to note some of the advantages we have in dealing with those challenges.

First, while a little over one-third of our exports go to East Asia, almost two-thirds do not. And many of those other markets continue to grow strongly at this stage. In the three months to April, New Zealand's exports increased by nearly 30 percent to the United States (our third largest market) as compared with the same three months in 1997, while those to Belgium and Italy increased by more than 50 percent. Even exports to some parts of East Asia increased during that period – to Hong Kong by 29 percent and to Singapore by 27 percent. While tourist arrivals from Korea in the month of May were down 89 percent as compared with the year earlier level, and from Thailand by 64 percent, overall visitor numbers were down only 7 percent as a result of increases in tourists from the US, Britain and Australia. Our exporters and tourist operators are showing considerable ability to switch from weak markets to more buoyant markets.

The decline in the New Zealand dollar against the currencies of the United States and Europe has greatly helped in this re-orientation of our markets.

Secondly, we go into this period of international turbulence without the grossly over-inflated asset prices which have been such a serious problem in many of the countries of Asia, and which were such a serious problem in Japan in the late eighties and early nineties. It is the pricking of these asset price bubbles which has often done so much damage to banking sectors and, as a consequence, to the real economies of the countries affected. Yes, I have at times lamented the high prices paid for both houses and rural land in New Zealand. I remain convinced that some of these prices reflected unrealistic expectations of future income growth. But the extent to which these prices got out of line with long-term trends was relatively minor compared with the inflation in asset prices in some of the countries of Asia. We are quite unlikely to see the 60 to 80 percent falls in such prices which have been common elsewhere in the Asian region. And we have not (in the last few years) seen 'price bubbles' in either commercial property or equities.

Of course, in part, the absence of significant asset price bubbles in New Zealand is a direct result of the fact that monetary policy here was leaning hard against inflationary pressures throughout the middle part of the decade. While that attracted a great deal of criticism at the time, it now means that we don't face the painful adjustments which inevitably follow when asset price bubbles burst.

Thirdly, and related in part to the substantial absence of asset price bubbles, we have a banking sector which is arguably as strong and as competitive as at any time in New Zealand's history. This is in marked contrast to the situation in all of the troubled countries of Asia. Indeed, the troubled countries of Asia are in an important sense *defined* as those where the banking sectors are in serious trouble.

Fourthly, we go into this period of turbulence with a ratio of net public sector debt to GDP of only some 25 percent, less than half the level as recently as 1992. This ratio is one of the lowest in the OECD. While the Government does owe some of this debt to foreigners, the foreign currency component of the public sector debt is exactly matched by foreign currency assets, so that the Crown has no net foreign currency debt at all. As everybody knows, Government has been running fiscal surpluses for the last five financial years, and is budgeting to continue doing so for the next three years. This clearly gives the country considerably more room to manoeuvre than if we were already running substantial fiscal deficits.

And perhaps most important of all, New Zealand has a floating exchange rate regime, and has had since March 1985. This has two hugely important implications. First it means that the value of the New Zealand dollar adjusts day by day and month by month as supply and demand change. This in turn means that if there is a perception that New Zealand is in a difficult period, for whatever reason, the New Zealand dollar tends to fall in value (and vice versa). This tends to offset some of the impact of a weaker international environment. And this is precisely what has happened over the last year or so, with the New Zealand dollar down from its peak by some 28 percent against the US dollar and by 17 percent against the Trade-Weighted Index (TWI). As a result, though the average *world* price of the commodities that New Zealand exporters sell declined by 10.8 percent over the last year, the *New Zealand* price of those exports actually rose by 9.3 percent over the same period.

Furthermore, having a floating exchange rate regime – one where everybody understands that neither the Government nor the central bank will interfere in the foreign exchange market to prop up the value of the dollar – strongly discourages banks and corporates from taking on unhedged foreign exchange liabilities. This means that when the New Zealand dollar moves substantially, as it has done over the last year or so, neither banks nor corporates incur the huge losses which have been commonplace in countries which have been forced to abandon fixed exchange rate regimes.[1] To the best of my knowledge, there has been nothing which could be called a foreign exchange crisis in any country with a floating exchange rate regime since 1945.

In a recent editorial, the Christchurch *Press* suggested that 'New Zealand is a child out in the economic storm this week - out in the storm without a hat or coat and with gumboots leaking'.[2] Certainly, the weather is getting rough, and may get rougher. But in my own view, we have good wet-weather gear and a sturdy four-wheel-drive vehicle.

Should policies be changed?

Are there things which Government should be doing to further assist the country weather the storm? Clearly, one of the issues being focused on currently is the desirability of Government's cutting back on some of its planned increase in expenditure because of the risk that, with slower economic growth a possibility, the projected operating surplus may turn into a deficit.

To the economist, cutting government expenditure in a growth slowdown seems counter-intuitive. Better, surely, to allow the 'automatic stabilisers' to work, with the Government's operating position moving into a small deficit when the economy is in the trough of the cycle and into a surplus at the peak. Moreover, there is quite a strong case for allowing longer-term considerations to determine fiscal decisions, in the light of considered judgements about the appropriate size of the public sector in the context of Government's economic and social objectives.

On the other hand, it must be acknowledged that the Government's determination to run fiscal surpluses throughout the cycle, and to achieve further reductions in net public sector debt, has been one of the important reasons why

1 Last week, the Government Statistician announced that the gross overseas debt of New Zealand banks and corporates had risen by $20.1 billion during the year to 31 March 1998, to reach a total of $79.0 billion. Of this increase, it was stated that $6.2 billion was on account of the increase in the New Zealand dollar value of foreign currency debt. It was also noted, however, that the figures took no account of 'hedging or other financial derivatives used by companies to offset potential foreign currency risk.' The significance of this note has almost certainly been missed by many commentators, because it is quite clear that all banks, and I suspect most corporates, hedge their foreign-currency denominated liabilities in full or in substantial part. Certainly at 31 March 1998, the four largest banks, which have been heavy borrowers of foreign funds in recent years, carried almost no foreign exchange risk on that borrowing. This means that the increase in the New Zealand dollar equivalent of the gross overseas liabilities of the banking system as a result of the depreciation in the New Zealand dollar, included in the debt figures published by the Government Statistician, will have been almost exactly matched by gains on the banks' currency hedges.

2 The *Press*, 23 June 1998.

foreign investors have been willing to finance New Zealanders' insatiable appetite for borrowing in recent years. Should there be no Government fiscal response to the present situation, and should a fiscal deficit subsequently emerge, the confidence of foreign investors could be somewhat undermined – with resultant upward pressure on interest rates and downward pressure on the exchange rate.

Moreover, in recent years it has been possible to argue that New Zealand's balance of payments deficit has been a result of investment exceeding saving in the *private* sector; the public sector was more than funding its own investment activities through its operating surplus. In 1998/99, the budgeted operating surplus looks likely to be broadly similar to public sector investment. If the operating surplus turns out to be less than now budgeted, perhaps because economic growth turns out to be slower than projected, it is possible that public sector investment will exceed the operating surplus. In other words, if the operating surplus turns out to be less than now budgeted, the public sector will be contributing to the balance of payments deficit in 1998/99 for the first time in several years.

If Government were to cut back on its own spending, this would further dampen demand in the domestic (non-tradeable) part of the economy. This would in turn permit some further easing in monetary conditions without putting price stability at risk, leading to stronger investment in export and import-competing sectors of the economy. The economic benefit would be faster reduction in the balance of payments deficit. The economic cost would be slower growth in the domestic (non-tradeable) part of the economy.

To the best of my knowledge, all commentators project a gradual reduction in the balance of payments deficit over the next few years on present policy. My own hunch is that the deficit will in fact reduce somewhat more quickly than any of the official projections (including that of the Reserve Bank) now suggest, as a result of the substantial fall in the real exchange rate over the last 12 months and a decline in imports which may follow an increase in household sector saving, in turn a result of a decline in house prices. It is already evident that growth in bank lending to the household sector has slowed markedly in recent months. Offsetting that, of course, is the risk of further reductions in export volumes as a result of the prolonged drought, and the weakness in some of our export markets.

At the end of the day, this decision about the trade-off between the speed of balance of payments adjustment and the strength of the domestic part of the economy must, of course, be a political judgement.

Whatever Government chooses to do with fiscal policy, it is obviously important to continue with the programme of micro-economic reform, which can play such an important role in building on the competitiveness of New Zealand producers in world markets.

What about monetary policy?

It is my absolute conviction that monetary policy targeted at maintaining price stability has a crucial role to play in the uncertain environment in which we now find ourselves.

Just as policy aimed at price stability must *tighten* monetary conditions as inflationary pressures increase, so policy aimed at price stability must *ease* monetary conditions as inflationary pressures abate.

And that is what the Reserve Bank has been doing for the last 18 months. For much of 1997, before the Asian crisis became a present reality, we eased gradually from a level of 1000 on our Monetary Conditions Index (MCI) in the December quarter of 1996 to around 650 in the December quarter of 1997. As it became obvious that the international environment was deteriorating, we allowed conditions to ease substantially faster, to around 250 over the last month.

The MCI seeks to measure the effect of both interest rates and the exchange rate on the real economy, and so on inflation. Perhaps not surprisingly, given New Zealand's balance of payments deficit and the uncertain international environment, the easing in monetary conditions over the last year or so has been entirely in the form of a fall in the exchange rate. Indeed, 90-day interest rates have actually risen somewhat over that period. But overall the easing which has taken place over the last 18 months is equivalent to a fall in 90 day interest rates of over 7 percent with unchanged exchange rate, a substantial easing in any language. Just as it was the export sector which bore much of the brunt of policy tightening between early 1994 and late 1996, so it has been the export sector which has received all of the benefit, so far, of the easing.

Ten days ago I attended an interesting conference in Stockholm on the best ways of conducting monetary policy. One of the papers at that conference[3] argued that, when the Swedish central bank became the first central bank to use monetary policy to try to maintain a stable price level in Sweden in the 'thirties, it had the important benefit that Swedish output and employment were also maintained at markedly higher levels than was the case in other countries at that time.

We in New Zealand do not target a price *level* but we have been charged with the responsibility of keeping inflation tightly constrained below 3 percent *and above 0 percent*. This does not imply that we can eliminate the economic cycle. The world is far too uncertain for that, and the lags between taking a monetary policy action and the effects of that action are both too long and too variable. (This means, incidentally, that there is nothing which monetary policy can do at this stage to affect the growth in GDP in the June quarter, which indeed is virtually over. There is virtually nothing which monetary policy can do at this stage to affect the growth in GDP in the September and December quarters. As far as monetary policy is concerned, those quarters are already substantially beyond influence. Whether they are quarters of strong growth or of weak growth will be determined by a range of domestic and international factors, one of which is monetary policy in 1997.)

But, provided we take our responsibility to keep inflation above zero as seriously as we take our responsibility to keep it below 3 percent, monetary policy should be able to protect the economy from any prolonged deflation and the loss of output and employment which that would entail. We have spent much of this decade fighting to keep inflation below the top of the target agreed with Government. It is at least possible that, over the next year or two, we will be working to prevent it from going through the bottom of that target. We will be as single-minded in that objective as we were in the earlier challenge. Indeed, we have been easing monetary conditions for more than a year with exactly that objective in view.

Having said that, we also need to be mindful of the risks in ignoring the long lags with which monetary policy works. If we ignore those lags, we run the risk of making economic cycles worse.

Alan Blinder, former vice-chairman of the Federal Reserve Board, sometimes uses the analogy of the thermostat. Who has not checked into a hotel room and turned up the heating because the room is too cold? Then, after having a shower, turned the heating up some more because the room is still cold. And finally woken up two hours later in a sweat, with the room like an oven. It takes time for central heating to warm up a room. It takes time for an easing in monetary policy to offset a sharp increase in deflationary pressures. If we keep easing until activity actually starts picking up strongly, we run the risk that in a year or two we will need to be slamming on the brakes. As we have sanctioned very substantial easing over the last year, we have been conscious of this risk. We have been conscious also that, with the sharp fall in the exchange rate which has taken place, import prices may be pushed up, with a risk that this might spill over into more generalised inflationary pressures. We recognise that, even now, with confidence quite low among both businesses and households, there is a strong increase in activity in some parts of the economy, particularly in those parts of the manufacturing sector which have benefited most from the fall in the exchange rate.

In short, while we can not eliminate cycles in economic activity, we believe that monetary policy aimed at price stability can smooth economic cycles to some degree. This means that when inflationary pressures increase, we can be relied upon to tighten. It means that when inflationary pressures fall away, perhaps because of a sharp deterioration in the international environment, we can be relied upon to ease. It certainly does not mean, as some commentators have asserted, that we operate in some kind of strait-jacket which requires us to suppress economic activity at every opportunity. Monetary policy aimed at delivering predictably low inflation enables the economy to maximise sustainable growth and employment opportunities.

[3] 'Pioneering price level targeting: the Swedish experience 1931-1937', by Claes Berg and Lars Jonung.

Conclusion

The sharp downturn in many of our major export markets may well turn out to be the most serious shock to hit the New Zealand economy since the oil shocks of the 'seventies. If so, the benefits of recent economic reforms, in reducing public sector debt and improving the flexibility and adaptability of the economy as a whole, will be evident for all to see. A monetary policy aimed firmly at price stability is of enormous benefit in weathering the storm.