

# Macro-economic policy and the export sector

By Donald T Brash, Governor

In recent months, there has been a great deal of public interest in how macro-economic policy affects the export sector, and particularly the farming sector. No doubt as a result, I have been asked to speak to a number of groups on this subject, again predominantly in the farming sector or at least in provincial areas. Because of the importance of this issue, it occurred to me that the main points I have been making might be of interest to a wider audience, and for this reason this article summarises the points I have been trying to make.

By 'macro-economic policy' most people mean both monetary policy (what the Reserve Bank does with interest rates) and fiscal policy (what the government does with taxation and government spending), but most of my comments in this article will deal with monetary policy, partly because it is the part of macro-economic policy for which the Reserve Bank carries direct responsibility and partly because it is monetary policy which has, in recent years, attracted a lot of criticism in the export sector. I want to advance five basic propositions.

But before I do that, I want to recall what New Zealand was like in the early eighties. At that time, and with the exception of a very brief period when inflation was artificially suppressed by tight controls on almost everything, inflation in New Zealand was well into double figures and had been above 10 percent for a decade.

Starting in the mid-eighties, the Government directed the Reserve Bank to focus monetary policy on getting inflation under control, and since 1991 inflation as measured by the CPI excluding interest rates has never been higher than 2.7 percent and never been lower than 1.0 percent. In other words, inflation has been low and stable for more than eight years.

And my first proposition is this: **Those in the export sector who argued in the early eighties that monetary policy should be committed to getting inflation under control were absolutely right.**

And there are two notions underlying that proposition. First, it is now widely accepted both here and abroad that monetary policy *can't* be used to crank up the growth rate in any kind of sustainable way. And monetary policy *can't* be used

**Figure 1**  
CPI ex-interest and GST inflation



to push up employment in any kind of sustainable way. But it *can* be used to control inflation.

And the second notion is that low inflation is good for the export sector.

Why is low inflation good for the export sector? Some used to argue that low inflation is good for the export sector because it improves the competitiveness of New Zealand producers as compared with producers in other countries. In other words, with costs going up more slowly in New Zealand than overseas, this was supposed to help New Zealand producers become more competitive. The reality, however, is rather different. If inflation is, say, 1 percent annually in New Zealand and 10 percent annually overseas, there will be a strong tendency for the New Zealand dollar to appreciate against the currencies of our trading partners, thus offsetting the lower inflation in New Zealand.

So what is the point of low inflation if it does not improve the competitiveness of the New Zealand export sector? Low inflation benefits the export sector in two important ways.

First, it benefits the export sector, as it benefits the rest of the economy, by improving the efficiency with which the economy as a whole operates. When inflation is low, price changes are relevant to the decisions people need to make about what to produce, what to buy, what skills to acquire, how much to save, and so on, because price changes represent something real, a change in the demand for something or a change in the supply of something. When, by contrast, inflation is high, price changes are very much harder to interpret – does a rising price communicate something about rising demand, or simply reflect general inflation? With low inflation, investment decisions are almost always better decisions than they are when inflation is high and variable.

Because of factors like this, most economists believe that an economy enjoying low inflation is likely to be able to grow *slightly* faster than one where inflation is high. Note that I said ‘slightly faster.’ No economist that I know of thinks that a low inflation economy can grow by 1 or 2 percent per annum faster than a moderate inflation economy, but it does seem clear that low inflation is associated with somewhat better and more sustainable growth than where inflation is higher. It seems entirely reasonable to expect that a low inflation environment, one where prices on average are broadly stable, helps producers to make sensible decisions about what to produce and how to produce it.

Secondly, low inflation benefits the export sector, as it benefits the rest of the economy, by reducing interest rates. If, for the sake of the argument, we assume that savers want to receive a 4 percent margin between inflation and the interest rate on their deposits, then with inflation at 2 percent deposit rates are 6 percent and lending rates may be around 9 percent. But with inflation at 10 percent, deposit rates may be around 14 percent, and lending rates may be around 17 percent. Most exporters, like most other borrowers, find it very much easier to find the cash-flow needed to meet a loan carrying an interest rate of 9 percent than they do to find the cash-flow needed to meet a loan carrying an interest rate of 17 percent, and that is true despite the fact that, in both cases in that illustration, the real, or inflation-adjusted, interest rate is the same.

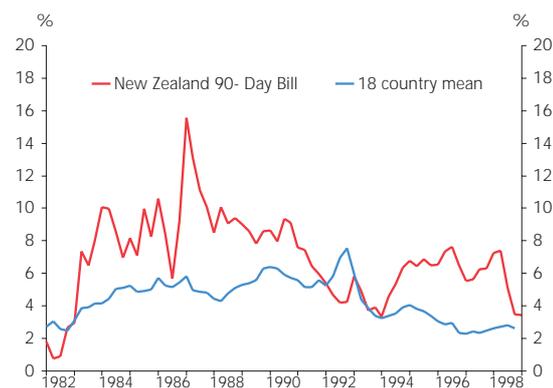
So, to repeat, those who argued that monetary policy should be committed to getting inflation under control were abso-

lutely right. And we have had inflation under control now for most of this decade.

But, exporters and others often ask, we’ve had low inflation for most of the decade and to be sure interest rates did not go anywhere close to the levels in the mid-eighties, but weren’t real, or inflation-adjusted, interest rates outrageously high in New Zealand through much of the nineties, and indeed, among the highest in the developed world? I think I have been asked that question more often than any other over the last decade. Why have New Zealand interest rates been so high in real terms?

And our interest rates *have* been high when compared with consumer price inflation.

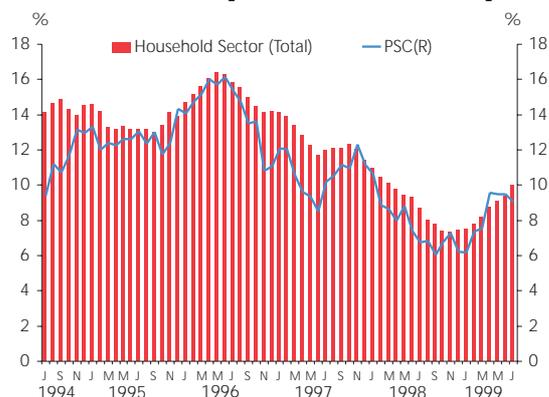
**Figure 2**  
Short-term real interest rates: NZ and selected OECD countries



But of course, whenever I am asked why our real interest rates have been relatively high (they are not so high relative to other countries at present), the answer I give is that they have been high mainly because New Zealanders on average didn’t actually *believe* them to be high. Yes, a great many of us would like them to have been lower, but we were more than willing to borrow at the then going rate. We were not enthusiastic about saving at those rates; we were enthusiastic about borrowing at those rates. And that tells us one thing very clearly: whatever our heads told us about interest rates being high in real terms, our hearts told us to borrow more and save less.

The data on saving in New Zealand is not terribly reliable, but for what it is worth it seems relatively clear that New Zealanders have been poor savers over the last decade.

**Figure 3**  
**Growth in resident private sector credit (apc)**



The data on our borrowing is much more reliable, and it is certainly clear that we increased the amount of our borrowings by a huge margin over the last 10 years. Lending by the main lending institutions has been growing at a goodly clip throughout the nineties, and much of that has been to individual borrowers, not to businesses.

And why has that been the case? I suspect it has something to do with the fact that much borrowing is to acquire assets which have nothing to do with the basket of goods and services covered by the Consumer Price Index. Indeed, much borrowing in recent years has been to acquire real estate, and if you think that real estate will go up in price each year by 10 percent, then borrowing at 11 percent seems to make eminently good sense, whatever inflation measured by the CPI is – and it seems like money for old rope if, in addition, the interest payments are fully tax deductible, which they often are with a bit of foresight. Because property prices – and I include the price of rural land as well as of Auckland houses! – have been increasing strongly until the last couple of years, it doesn't seem in the least surprising that people have been more enthusiastic about borrowing than about saving, and that our interest rates have seemed relatively high.

Of course, if our interest rates rise above those overseas, there will be a tendency for overseas savers to invest in New Zealand, and in recent years the willingness of foreigners to lend us their savings has been a material factor in helping to keep our interest rates lower than they would otherwise have been.

But while in principle real interest rates in New Zealand will be related to real interest rates overseas because we can

borrow the savings of foreigners in this way, foreigners will want a margin above the real interest rate which they can get at home to compensate them for the additional risk which they see in investing in New Zealand – the risk of investing a long way from home, the risk of investing in an unfamiliar political environment, the risk of the exchange rate falling because of a fall in the international prices of the goods New Zealand exports, the risk of the exchange rate falling if our dependence on foreign savings (or in other words our current account deficit) gets too large, and so on.

We can't totally determine the real interest rate in New Zealand, because that depends in part on what the real interest rate is overseas. But we can reduce the real interest rate faced by borrowers by ensuring that we have a competitive banking sector (which helps to minimise the margin between what savers require to compensate them for saving and what borrowers have to pay), and by reducing the risks which savers see in investing their savings in New Zealand dollars. Reducing those risks is at least in part about delivering predictably low inflation. The longer we enjoy low inflation in New Zealand, the more confident savers will be – and I am talking about both New Zealand savers and the foreign savers who provide their savings to us – that the purchasing power of their savings will be protected. This will tend to reduce the risk premium in interest rates, to the benefit of both savers and borrowers.

So my second proposition is this: **the best contribution which the Reserve Bank can make to keeping real interest rates low is to keep on delivering predictably low inflation.** In time that will make savers more confident that their savings in New Zealand dollars will keep their value, and willing as a consequence to provide their savings at lower interest rates.

As Karl Otto-Poehl, a former President of the German central bank, the Bundesbank, once told me, 'If you want to get interest rates down in New Zealand, you must convince savers that you will not hesitate to push interest rates *up* if that should be necessary to protect the purchasing power of their savings. As long as they remain convinced of that, interest rates will remain relatively low. If they ever come to doubt that, then no matter what you do interest rates will be relatively high.' I am convinced that the best contribu-

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tion that the Reserve Bank can make to keeping interest rates at a low level is to keep on delivering low inflation.

But what about the exchange rate? Isn't it true that the Reserve Bank deliberately pushed up the exchange rate in the mid-nineties in order to keep inflation under control, and by so doing imposed an enormous burden on the export sector, and indeed on import-competing industries? Isn't it true that, had it not been for the strong appreciation of the exchange rate between early 1993 and early 1997, exporters would have been vastly better off than in fact they were?

No, we did not deliberately push up the exchange rate in the mid-nineties, and indeed on several occasions I publicly expressed the view that the exchange rate appreciation seemed to me to have been excessive. What we *did* do is operate monetary policy with the single objective of keeping inflation under control. This undoubtedly meant that at times we increased interest rates to make borrowing *less* attractive and saving *more* attractive, and one of the consequences of this was to make the New Zealand dollar more attractive to foreign savers. This tended to push up the exchange rate as foreign savers bought New Zealand dollars to take advantage of the higher interest rates. (Or put another way, because New Zealanders wanted to borrow more than they wanted to save at existing interest rates, interest rates had to increase to persuade foreign savers to lend us some of their savings, despite the risk of investing in New Zealand dollars.)

And I haven't the slightest doubt that the increase in the international value of the New Zealand dollar between early 1993, when it was around 53 on the Trade-Weighted Index, and early 1997, when it peaked at around 69 on the Trade-Weighted Index, significantly reduced the gross income of many exporters, below the level which would have prevailed if the exchange rate had not appreciated.

But the dollar reduction in exporters' *net* income was certainly a good deal smaller than the reduction in their *gross* income. Why? Because the strong rise in the exchange rate reduced not only exporters' gross income but also many of their costs – there can be not the slightest doubt that if the exchange rate had not appreciated the price of diesel fuel would have been higher, the price of fertiliser would have

been higher, the price of tractors would have been higher, and the price of the imported components used by many exporters would have been higher. The price of a great many of the services bought between farm or factory gate and the market would also have been higher in New Zealand dollars.

Moreover, if monetary policy had not been tightened, domestic inflation within New Zealand generally would have been higher – so that wages paid to staff would have been higher, clothes for the family would have cost more, doctors' bills would have cost more, and all the rest.

So the damage done to exporters' net incomes was a good deal less, in dollar terms, than the simple reduction in gross incomes would suggest.

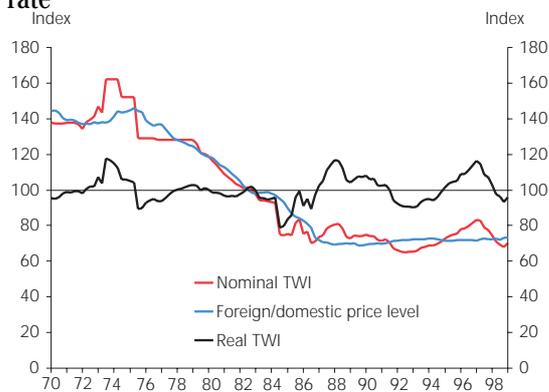
Having said that, I would be the first to concede that when monetary policy is tightened to keep inflation under control, exporters feel some of the pressure. (Not all of it of course, because those competing with imports also feel the pressure, as do all those who need to borrow, whether exporters or not.) I don't have any doubt that life for New Zealand exporters would have been a good deal less complicated if the exchange rate had not risen by some 29 percent, in real trade-weighted terms, from trough to peak.

For this reason, and to try to avoid a repetition of this experience, we in the Reserve Bank have undertaken a major study of how the economy has evolved over the last decade, and how monetary policy has impacted on that evolution. The key conclusions of that study as they relate to the matter in hand are as follows:

- New Zealand was only able to keep inflation low during the mid-nineties by leaning hard against quite strong inflationary pressures. Those pressures were the result of a whole range of factors, including very strong growth in borrowing, probably in turn a result of a combination of considerable optimism on the part of both businesses and private individuals and a recently deregulated financial sector; strong increases in demand arising from very strong net inwards migration; still-strong inflationary expectations, at least in the property market; and from 1996 on a considerable easing in fiscal policy, through both increased government spending and reduced taxes.

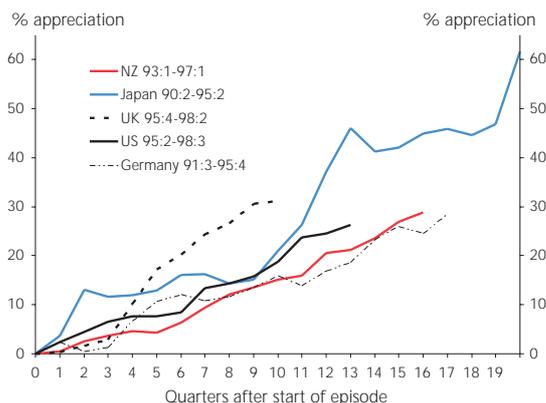
- ‘Leaning hard against quite strong inflationary pressures’ meant that our real interest rates were quite a bit higher than they were overseas, as I have already mentioned. This put upward pressure on our exchange rate between early 1993 and early 1997, so that the real trade-weighted exchange rate moved from what was a level well below its long-term average to a level well above its long-term average.

**Figure 4**  
Nominal and ‘real’ trade weighted exchange rate



- To our considerable surprise, the real exchange rate appreciation we experienced over that period, of about 29 percent, was by no means unusual when compared with the experience of many other countries during the nineties. Thus for example, from trough to peak the pound sterling appreciated by some 31 percent, the Japanese yen by some 60 percent, the US dollar and the German mark by only slightly less than New Zealand’s appreciation.

**Figure 5**  
Recent episodes of exchange rate appreciation



- Perhaps most disturbing of all, we can’t be confident of avoiding similar real exchange rate appreciations in the future. Perhaps the slightly wider inflation target that we have had since December 1996 will help a little by enabling monetary policy to react with somewhat less vigour than previously. We would also like to hope that better Reserve Bank forecasting – so that we tighten monetary policy a bit earlier, to avoid inflationary pressures building up – would help the situation. But by the nature of the case, forecasting involves a high degree of uncertainty, so we can not be confident that we will always be able to avoid similar situations in the future. Certainly other countries have not avoided the problem. Moreover, even abandoning the New Zealand dollar and forming a currency union with somebody else doesn’t avoid the problem. During the nineties, Hong Kong’s currency, pegged as it is to the US dollar, appreciated by *more* than the New Zealand dollar did in real terms, and I have very little doubt that we would have experienced a bigger real appreciation also had we been pegged to the US dollar over the last decade. Argentina, also pegged to the US dollar, experienced a real appreciation of more than double the appreciation which we experienced.

So my third proposition is this: the Reserve Bank has very limited effect on the real exchange rate except in the very short term, and adopting an alternative exchange rate regime does not appear to solve the problem of swings in the real exchange rate either.

It is at this point that I want to touch briefly on the other key aspect of macro-economic policy, namely fiscal policy. Fiscal policy, of course, is all about how much government takes out of the economy in taxation and how much it spends.

I do not propose to get into the debate about how big the government sector of the economy should be, although as you would expect I have personal views on that issue. Rather what I want to note, and note strongly, is that changes in the fiscal policy of the government can have important implications for how much work monetary policy has to do, and that in turn has important implications for real interest rates and the real exchange rate.

**Table 1**  
**Cumulative inflation-adjusted price changes in selected commodity prices – from, 1948 to 1996**

Commodity	US price % change	NZ price % change
Cotton	-66	-
Wool	-79	-72
Lamb	-45	-42
Beef	-69	-28
Dairy	-55	-49
Wheat	-69	-

*Source: Meat and Wool Economic Service of New Zealand*

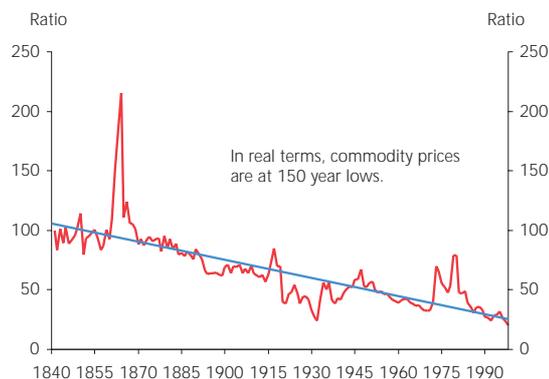
We have had two illustrations of that in the last decade. The first was in 1990, when we judged that a major easing of fiscal policy required the Reserve Bank to tighten monetary policy if the inflation target we had been set by Government was to be met.

The second was in the mid-nineties, when the combination of a reduction in income tax rates and an expansion in government spending meant that monetary policy had to remain tighter for longer than would otherwise have been the case.

To be fair, it is often easier to see these issues in retrospect than in prospect. The Government formally asked the Reserve Bank in late 1995 whether we felt that income taxes could be reduced in mid-1996 without requiring any significant tightening of monetary policy. We judged that the economy would be considerably more subdued in 1996 than it had been in the mid-nineties, so indicated that we saw no problem for monetary policy in the proposed reduction in taxes. With the wonderful benefit of hindsight, it is clear that the economy was more buoyant in 1996 than we and other observers had expected and that the tax cuts, added to the additional government spending which occurred as a result of the Coalition Agreement of December 1996, required monetary policy to be tight throughout 1996.

So my fourth proposition is: **monetary policy can keep inflation low and stable, but how tight monetary policy has to be to achieve that objective can be materially affected by changes in fiscal policy.** Sharp increases in government spending unmatched by increases in tax reve-

**Figure 6**  
**US commodity prices to US CPI**



nues, or sharp reductions in tax revenues without corresponding reductions in government spending, will have implications for interest rates and the exchange rate. And many exporters have long recognised that important relationship.

My fifth and final point is that the most exporter-friendly macro-economic environment – with low inflation, gradually declining real interest rates, possibly some reduction in the swings in the real exchange rate, and eminently responsible fiscal policy – can only indirectly help with one of the big underlying realities facing exporters of commodities, and that is that **over the long-term, there is every reason to expect commodity prices to continue to decline in real, inflation-adjusted, terms.**

Figure 6, showing the trend decline in commodity prices in the US since 1840, tells a sobering story. New Zealand farmers have had a similar experience.

The export product I am most familiar with is kiwifruit, and there the orchard-gate price has declined by about 80 percent in inflation-adjusted terms since 1982. Will that trend, for kiwifruit, or for lamb, or for wool, or for beef, or for dairy products, change in the future? I certainly hope so, but I would not want to bet the farm on it.

And of course that trend has nothing to do with macro-economic policy. The market price of commodities has trended down through all kinds of macro-economic policy, in New Zealand and in overseas countries. And it has been true not only of agricultural commodities but for oil and minerals also, and indeed for many other goods and services. The fall in the real price of computers in recent years has been vastly greater even than the fall in the price of kiwifruit,

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while the real price of long-distance telephone services has fallen by more than 99 percent in the last 60 years. So falling real prices is not a phenomenon confined to primary products – it has happened for many manufactured goods, and for some services as well.

What does this mean? I think it means that, important as macro-economic policy is, the real challenges facing the export sector lie not in macro-economic policy but in a whole range of other crucial areas – in improving productivity, in matching the quality of production to what the market wants,

and in better marketing. Those are the real challenges facing the export sector. Macro-economic policy at its best can provide an environment where exporters and those serving the export sector can address those crucial challenges. But the basic fact remains: macro-economic policy only provides the environment. That is a valuable contribution to the prosperity of the export sector. But macro-economic policy can not by itself generate prosperity for the New Zealand export sector.