Will the Reserve Bank choke the recovery?

An address by Donald T Brash, Governor of the Reserve Bank of New Zealand to the Auckland Regional Chamber of Commerce & Industry on 21 March 2000.

Introduction

Ladies and Gentlemen:

I was invited to give this address after a number of pretty aggressive attacks on the Reserve Bank, on monetary policy, and on me personally in the Auckland media in late January and early February, after the Bank increased the Official Cash Rate from 5 percent to 5.25 percent in the middle of January.

Who does Don Brash, an unelected bureaucrat whose name appeared on no ballot paper in the last election, think he is, to be making such important decisions?

Why does Don Brash refuse to engage publicly with any of the media on the issue?

Why is New Zealand the only OECD country that "persists in intervention to fuel another self-induced recession" (this from the Auckland Chamber of Commerce itself, using the same words after our increase in the Official Cash Rate in January, and again after the further increase last week)?

Wouldn't life be much better if we simply did away with such intervention, and allowed pure market forces to determine interest rates?

Hasn't the Reserve Bank, and the way in which it has run monetary policy under the Reserve Bank Act of 1989, caused New Zealand's huge balance of payments deficit, and won't pushing up the Official Cash Rate simply make matters worse?

Why did the Bank increase the Official Cash Rate as the economy was just beginning to emerge from the recession?

Surely it was inappropriate to tighten policy when the Government Statistician has shown that inflation in the latest year was below the mid-point of the 0 to 3 percent inflation target?

Why does the Reserve Bank claim the right to be the sole judge of how fast the New Zealand economy can grow?

Isn't it possible that New Zealand, like the United States and other developed countries, can now grow faster than before without inflation?

These and other questions poured forth – and this despite the fact that January's modest increase of 25 basis points had already been fully priced into financial markets (as indeed last week's adjustment to the OCR had been also)!

Some questions based on misunderstanding

I welcome the opportunity to respond to these questions this morning. Some of them raise important issues, though I think it is fair to say also that others simply reflect misunderstandings.

For example, and contrary to the view once expressed by former Prime Minister David Lange, there is no sense in which Don Brash has huge or unfettered power. Parliament has made it clear that the Reserve Bank must use its ability to influence monetary conditions to maintain price stability. Parliament has made it clear that what price stability means has to be the subject of a formal agreement between the Government and the Bank's Governor. And of course, that agreement currently requires me to keep the CPI inflation rate between 0 and 3 percent (with some qualifications). The Government has made it clear that that is what I have to deliver, and under the Reserve Bank Act the Government has the right to change that target, unilaterally if they wish to do so, provided that any change is made public.

So any decisions which Don Brash makes are tightly constrained, are based on the best information which my colleagues can gather, and are made to achieve an objective which Parliament has laid down. In no sense am I an unconstrained bureaucrat.

The suggestion that I am reluctant to engage in debate with the media arose, I suspect, because in January we issued a press statement announcing and explaining the increase in the Official Cash Rate but then declined to answer further media questions. It is always a difficult judgement about how frequently the Bank should comment on monetary conditions "on the record". On that occasion, I felt that had I given an interview to one journalist I would have had to give interviews to quite a number, and I was reluctant to run the risk of sending a multiplicity of messages which might have confused more than it enlightened. In general, however, we are more accessible to the media than any other central bank that I know of, and no central bank is more transparent about the rationale for its decisions.

And have we been the only central bank in an OECD country to adjust monetary policy in a tightening direction in recent times? Hardly. In the last six months, the central banks of Australia, Canada, Sweden, Switzerland, the United Kingdom, the United States and the European Monetary Union have all tightened monetary policy on several occasions. That in itself does not make it sensible for us to tighten policy, of course, but at very least it makes it clear that what we have been doing is typical of what is happening in many parts of the world.

But why not let "pure market forces" determine interest rates? As somebody who has a great deal of confidence in market forces, it feels a bit strange to have to disagree with those who advocate letting market forces be the sole determinant of interest rates. Of course, market forces do determine interest rates to a very large degree. Central banks really have a strong influence only on short-term interest rates. But why do we need central banks at all? This is not the place to give a comprehensive answer to this question.[1] But it might be worth noting that, to the best of my knowledge, no country in the world currently operates without the services of a central bank. In other words, all countries that I am aware of have their own central bank, or effectively use the services of another country's central bank (through using that other country's currency, or tying their own currency to that of some other country). And all of those central banks intervene, as we do, by influencing short-term interest rates.

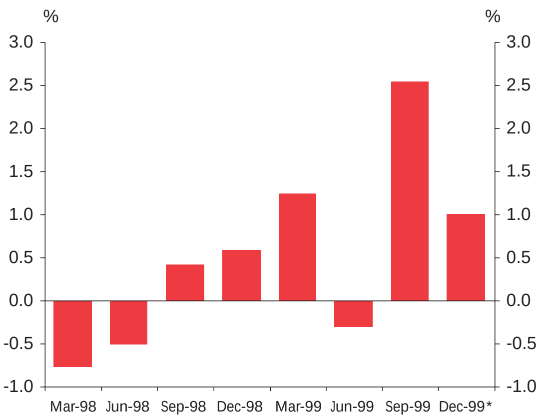
What about the balance of payments? Surely, the Reserve Bank and its obsession with price stability have been a major contributor to the large current account deficit which New Zealand has experienced over the last decade? Well, actually no. New Zealand has had a current account deficit in every year since 1974, through a range of monetary policy regimes. Indeed, the largest deficit experienced over that 25 year period, relative to GDP, was in the mid-seventies, with another very large deficit in the mid-eighties.

I am myself absolutely persuaded that, even if the Reserve Bank Act were amended to make the Bank responsible for reducing the balance of payments deficit, monetary policy has no ability to produce any sustainable reduction in that deficit. Indeed, I do not even know whether reducing a current account deficit would involve tightening monetary policy (which would push up the exchange rate but slow down domestic spending) or easing monetary policy (which would tend to push down the exchange rate but accelerate domestic spending).

But surely it was daft for the Reserve Bank to tighten policy just as the New Zealand economy was emerging from a recession? Well, it might have been daft to do that if that is what we had done, but of course we did not. New Zealand experienced a brief, mild, recession in the first half of 1998, in significant part because of the impact of the Asian crisis and of a severe drought. But the economy started growing again in the third quarter of 1998, and despite a few wobbles has been growing with increasing vigour since that time.

Figure 1
Real GDP

(seasonally adjusted, quarterly percentage change)



** December 1999 uses projections (March 2000 Monetary Policy Statement).*

[1] But see "Monetary policy and the free-market economy", an address to the Auckland Manufacturers' Association, 22 February 1996.

Most commentators believe that over calendar 1999 the economy grew by over 4 percent, and that is in line with our own estimate. (We know that the economy grew by 3.1 percent in the first three quarters of the year, and our *Monetary Policy Statement* published last week suggested that December quarter GDP grew by a further 1 percent. Many commentators are already suggesting that that 1 percent estimate will prove to be too low.) It also seems very clear that as a result of that growth the small amount of excess productive capacity which existed in the economy through much of 1998 and 1999 has now been largely, or perhaps completely, used up. A tightening of monetary policy over the last four months has been entirely appropriate.

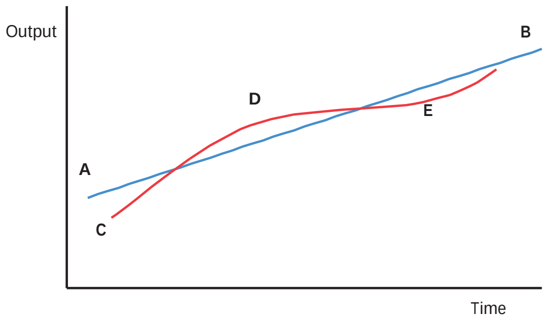
So those are the questions and comments with which it is pretty easy to deal.

More fundamental questions

But there are some fundamental questions which must be taken more seriously, questions about the relationship between inflation and growth which go to the heart of monetary policy decision-making. How fast can the New Zealand economy grow without generating inflation? What does 1999 tell us about the answer to that question? Let me try to answer those questions, while acknowledging that in some areas we ourselves do not have answers. Before doing that, it may be helpful to explain something about the way we look at this issue.

This is best illustrated in a graph.

Figure 2
The business cycle



The straight line A/B represents the gradual growth in the economy's capacity to deliver goods and services without inflation. If demand exceeds the line A/B, then prices will have a tendency to rise. If demand falls short of that line, then prices will have a tendency to fall. (I say "have a tendency to rise" and "have a tendency to fall" because of course there are many other things which have an influence on prices, including changes in international prices, changes in government charging policy, changes in tariff policies, and similar factors.)

The slope of the line, in other words the trend rate of growth in the economy's capacity to supply, is largely driven by factors like the growth in the labour force, the quality of the education system, the quality of management decision-making, the openness of the economy, the quality of the judicial system, the quality of the industrial relations framework, and so on. Monetary policy can help by delivering price stability, because that helps people interpret relative price changes more easily than they can do in the presence of high and variable inflation, and avoids the distortions which the interaction of inflation with the tax system often creates. But the main factors affecting trend growth are the other ones I have mentioned. Monetary policy helps at the margin by keeping prices stable.

In practice, of course, A/B is not a straight line – it varies in response to a whole raft of factors, including things like changes in net migration.

Like the capacity to supply, demand also tends to fluctuate – in response to changes in international conditions, in response to changes in public confidence, in response to changes in government policy, in response to the introduction of new inventions, in response to changes in wealth, in response to a whole host of things – and yes, in response to changes in monetary policy.

The key point to note is that when demand falls short of the economy's capacity, as at points C and E, it is possible for the economy to grow rapidly while at the same time inflation is low or falling. Conversely, when demand exceeds the economy's capacity, as at D, it is perfectly possible for the economy to grow very slowly, or indeed even to shrink somewhat, while at the same time inflation is rising. It seems to me that, conceptually at least, point C represents the state of the New Zealand economy in the early nineties (with very rapid growth but low inflation despite a big fall in the exchange rate); D represents the state of the economy in 1996 and 1997 (with growth slowing but inflation pushing up to and beyond the top of the then 0 to 2 percent target range); and E represents where we have been over the last couple of years (with the economy first contracting briefly, then growing quite strongly, but with inflation low or falling).

Seen in this light, we should perhaps not have been surprised that there was very little inflation in the second half of 1999, despite the fact that growth in that half of the year probably ran at an annualised rate of over 6 percent; or that inflation in the year as a whole was just 1.3 percent, despite growth in the whole year of at least 4 percent. As already mentioned, other factors influence the inflation rate in the short-term of course – things like international oil prices, changes in government pricing policies, and so on – but the trend inflation which is the proper focus of monetary policy is basically a function of the relationship between demand and the economy's capacity to supply.

But of course this tells us nothing about how fast the New Zealand economy can grow without generating inflation. What is that "sustainable growth rate"? What, in other words, is the slope of the line A/B? Nobody, and certainly not the Reserve Bank, knows the answer to that question with certainty. But because the answer to the question is so fundamental to our decisions about monetary policy, we can not avoid making an estimate of that sustainable growth rate. We are forced to reach a judgement on the matter.

At the present time, we estimate that the sustainable growth rate of the New Zealand economy is around 3 percent per annum. Of course, the economy can grow faster than that for a time if it starts from a situation of excess capacity, as was the case in the early nineties and was the case in mid-1998. But when that excess capacity is used up, the economy needs to slow to about the sustainable growth rate or risk inflation beginning to pick up.

Some people worry that the Reserve Bank can do considerable damage to the economy by assuming too low a sustainable growth rate, by assuming, say, a 3 percent growth rate where in reality the economy could grow at 4 or 5 percent if only the Bank would allow demand to expand more rapidly. But if the economy is really capable of growing at 5 percent and the Bank runs monetary policy on the assumption that it is only capable of growing at 3 percent, then quite quickly demand will fall below capacity to supply, there will be a strong tendency for prices to fall, and the inflation rate gets pushed down towards the bottom of the 0 to 3 percent target range. And since we take not going through the bottom of the target as seriously as we take not going through the top, we are forced to ease monetary policy to let demand expand. In other words, we can't avoid making a judgement about sustainable growth, and we can't get it wrong for too long before we are forced to adjust our estimate.

Indeed, we had a rather higher estimate of the sustainable growth rate of the economy in the mid-nineties but revised it down as we found inflation consistently pushing up towards, and briefly beyond, the top of the target range. Whenever any new piece of data comes out about inflation or GDP, we look again at whether our current estimate of sustainable growth is still reasonable.

What about the "new paradigm"? As discussed in our *Monetary Policy Statement* last week, there are those who believe that recent US experience, with rapid growth and low inflation, points towards some new ability for modern economies operating with the latest technology and in competition with producers from all over the world to grow more rapidly than previously believed without inflation. Local optimists argue that New Zealand too could see more rapid growth with low inflation if only the Reserve Bank were not so cautious.

Others suggest that, even in the US, the conjunction of low inflation with rapid growth has reflected in large part the disinflationary impact of some one-off factors, such as the recent weakness in world commodity prices, and the recent strength of the US dollar. They note that there is not yet any strong evidence in New Zealand to suggest that there has been a significant increase in the trend rate of productivity growth of the sort which might be required to justify a belief in the "new paradigm" in New Zealand.

As our *Statement* last week noted, we are not yet persuaded that there is evidence of any fundamental change in the relationship between growth and inflation in New Zealand. But we are open-minded on the issue, and will continue to examine the data for evidence of such a change. Indeed, a whole section of the *Statement* was devoted to acknowledging that, while we have no doubt about the need to reduce the stimulus which monetary policy has been providing to the economy in recent times, there is much less certainty about how far monetary policy will need to tighten beyond the next few months.

Conclusion

And this is my main message to you today. All the evidence suggests that, after a very brief recession two years ago and growth of 3 to 4 percent per annum since the middle of 1998, the excess productive capacity in the economy is largely gone. (In other words, referring back to my graph, we have passed point E and the demand line is very close indeed to the supply line.) It was appropriate that monetary conditions were stimulatory while demand fell well short of capacity. If we are right that demand and supply are now close to balance, however – and there is now a large body of official statistics and unofficial anecdotes supporting this view – it is high time that this stimulus was removed. And of course that is what we have been seeking to do with the increases in the Official Cash Rate in November, January, and now in March. We project that we will need to continue this reduction in stimulus, this easing back on the accelerator, over the next few months.

But will we need to step on the brakes, and if so, how hard? The answer, as so often in economic matters, is "it depends." Our *Statement* projects some need for monetary policy to become restrictive, to apply the brakes, over the next year or two. But at this stage this seems likely to involve a rather milder tightening in monetary conditions than has been the case historically.

One of the reasons for this belief is that New Zealanders now carry a lot more debt, relative to their incomes, than they did a decade ago. We are assuming a relatively moderate rate of growth in household sector expenditure in the next few years as a result. In particular, we are assuming that the rate at which new debt is taken on will slow down as compared with the nineties, and that increases in interest rates will have a bigger impact on consumption expenditure and even on new house-building than in the nineties.

Of course, we could be wrong on this assumption, in either direction. There is not much evidence yet that increased debt levels have encouraged a slow-down in the rate at which consumption is growing, so it is possible that demand arising from the household sector will be stronger than we now project, requiring firmer monetary conditions than we now project.

Conversely, debt levels may be such that even small increases in interest rates induce a slow-down in consumption spending and in house-building, requiring monetary conditions to be rather easier than now projected.

Another important area of uncertainty is the exchange rate. At the present time, the New Zealand dollar is close to its lowest level ever, on a trade-weighted basis. There are many reasons for this. New Zealand short-term interest rates have been lower than those in several other English-speaking countries, providing little inducement to foreigners to invest in New Zealand dollar assets. The commodity prices of greatest relevance to New Zealand seem to be recovering rather more slowly than do some other commodity prices. There has been some nervousness about the political environment, among investors both here and abroad. New Zealand has a large current account deficit, which looks likely to improve only slowly.

To the extent that the exchange rate is weak because of low commodity prices, we know that offsetting the stimulus of the low exchange rate is the disinflationary effect of weak export prices. This would suggest no need for monetary policy to react.

On the other hand, to the extent that exchange rate weakness simply reflects other factors, such as the current account deficit or nervousness about the political environment, the Bank may well need to adjust monetary policy to avoid the total demand pressures on the New Zealand economy exceeding the country's capacity to supply. In this event, of course, interest rates may need to rise by more than projected in our *Statement* last week, as I noted at that time.

But of one thing you can be absolutely certain. The Reserve Bank has absolutely not the slightest interest in choking off the recovery. All the evidence suggests that the economy has been growing with increasing vigour over the last couple of years, and most commentators expect it to continue growing at between 3 and 4 percent per annum for at least the next couple of years. All the evidence suggests that, in these circumstances, it is high time to ease off the accelerator and ponder whether to touch the brakes.

As Ian Macfarlane, the Governor of the Reserve Bank of Australia, said recently, an alternative way of describing the objective of a central bank committed to safe-guarding price stability is to say that the central bank wants to let the economy "grow as fast as possible without breaking the inflation objective, but no faster".[2] That is exactly how I see the mission of the Reserve Bank of New Zealand.

Price stability is not an end in itself. Rather, it has always been the best contribution which monetary policy can make to allowing the economy to grow at its maximum sustainable pace.

[2] Speech by Mr Ian Macfarlane, Governor of the Reserve Bank of Australia, to the CEDA annual general meeting dinner, Melbourne, 28 November 1996.