Can the Reserve Bank ignore the current increase in inflation?

An address by Donald T Brash, Governor of the Reserve Bank of New Zealand to the Electralines Business Breakfast Forum on 2 August 2000.

Introduction

In the middle of May this year, when the Reserve Bank last issued a quarterly *Monetary Policy Statement*, we projected inflation in the June quarter to be just 0.3 per cent, and inflation in the year to March 2001 to be just 1.6 per cent.

What a lot can change in two and a half months! Even before that May *Statement* was published, the Government had sharply increased the tax on cigarettes, adding around 14 per cent to their price. Within hours of the publication of that May *Statement*, the trade-weighted measure of the New Zealand dollar had depreciated close to its lowest level in history. Within weeks of the publication of that May *Statement*, the price of petrol had increased by some 15 per cent, the result of a sharp further increase in the international price of oil and of the depreciation of the New Zealand dollar.

As a result, it was clear well before the announcement of the actual inflation figure for the June quarter, of 0.7 per cent, that inflation for that quarter would considerably exceed our original estimate of 0.3 per cent, and that inflation for the year to March 2001 will almost certainly considerably exceed our estimate of 1.6 per cent.

Some commentators are suggesting that inflation is now likely to exceed 3 per cent for the year to December 2000, and almost all commentators are at least expecting inflation to well exceed our mid-May estimate.

What does this imply for the way in which the Reserve Bank implements monetary policy? It is clearly inappropriate for me to speculate on what we may or may not do when we release our August *Monetary Policy Statement* in two weeks' time, but I want to use this occasion to reiterate and emphasise some of the points relevant to this issue. In all cases, these points have been made previously, but I suspect that some of them may have been forgotten or ignored.

Of caveats and underlying inflation

The first point to reiterate is that, from the time I signed my very first agreement with the Minister of Finance (the Hon David Caygill) in early 1990, shortly after the passage of legislation requiring the Reserve Bank to use monetary policy to deliver price stability, the Bank has been expected not to react to price changes arising from things like big changes in international prices and changes in indirect taxes.

We used to refer to these things as “caveats”, and to calculate the inflation rate excluding the impact of such “caveatable” shocks. For convenience, we used to refer to the inflation rate excluding such caveatable shocks as the “underlying inflation rate”.

In the agreement I signed with the present Minister of Finance, the Hon Dr Michael Cullen, in December last year, as in the agreement signed with the Rt Hon Winston Peters in late 1997, the wording is slightly different from the wording used in 1990, but the substance is the same, namely that

“There is a range of events that can have a significant temporary impact on inflation as measured by the CPI, and mask the underlying trend in prices which is the proper focus of monetary policy. These events may even lead to inflation outcomes outside the target range. Such disturbances include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy. When disturbances of (this) kind…arise, the Bank shall react in a manner which prevents general inflationary pressures emerging.”

And the Reserve Bank is directed to ignore, or “look through” in the jargon, the price effects of such events not in order to make *my* life easier but to make *your* life easier. In other words, the Bank is directed not to react to such one-off price shocks on the grounds that trying to offset them would involve more economic cost than would be warranted. For example, while monetary policy could in principle be tightened aggressively so that other prices in the economy would fall sufficiently to offset the direct price effects of an increase in the international price of oil, the Minister has decided, and I have agreed, that doing that would involve more economic and social damage than could be justified.

We no longer calculate "underlying inflation" in the way we used to do, and that is true for a whole raft of reasons, including the fact that there was always some public suspicion that "underlying inflation" was a Reserve Bank invention to help Don Brash keep his job. But the reality which that term reflected is as valid today as it was a decade ago. In other words, we are not interested in trying to use monetary policy to suppress the price changes which emanate from international oil price changes or from changes in indirect taxation.

And when we look forward to the end of the year, it seems pretty clear that much of the sharp increase in inflation which is now expected by most commentators will be the direct result of such factors, and should as a result be ignored by the Reserve Bank in setting monetary policy.

Partly because we expressly don't react to certain kinds of price changes, actual inflation can often be expected to fluctuate over quite a wide range – certainly over the full 0 to 3 per cent range, and occasionally outside that range. And we set interest rates with the objective of keeping inflation somewhere near the middle of the target range in one to two years' time precisely because we know that in practice there will be all sorts of unexpected shocks and developments, ranging from Asian crises to changes in cigarette taxes, which will move prices both up *and* down, away from that mid-point. We improve our chances of having inflation remain within the target range most of the time by constantly aiming to keep inflation near the mid-point of the range in the medium-term. But we recognise that there will be all kinds of developments which will result in somewhat different outcomes, and indeed *should* result in somewhat different outcomes.

But it is crucially important to stress that the Reserve Bank can ignore the impact of these one-off "shocks" to the inflation rate only if we New Zealanders do not use them as an excuse to start a more generalised and enduring increase in the inflation rate.

If a doctor, in reviewing his or her fees, says "Well, the CPI went up by 3 per cent, so I had better put up my fees by 3 per cent also", then we have a problem.

If a producer of widgets sees that the CPI has increased by 3 per cent, and automatically puts his prices up too, then we have a problem.

If local authorities see a 3 per cent increase in the CPI as adequate justification for them to increase rates and fees by that amount, then we have a problem.

And if wages and salaries are automatically increased by 3 per cent to compensate for the increase in the CPI, then we have a problem.

The reality is that, when the international price of oil goes up – to use the current example – we New Zealanders become poorer, and it is utterly futile to suppose that we can compensate ourselves for that fact by giving ourselves higher incomes. To the extent that some New Zealanders succeed in winning such compensation, the gain is achieved at the expense of other New Zealanders, since in aggregate we are all worse off.

To put it bluntly, if the Reserve Bank is to be able to "look through" the impact of things like the increase in petrol and cigarette prices in implementing monetary policy, we New Zealanders also need to "look through" the impact of those things on the CPI. To the extent that we don't, and instead seek compensation for the impact of those things on the CPI, the Bank will need to tighten monetary policy to a greater extent. The only alternative would be permanently higher inflation, and that would help nobody and hurt those least able to protect themselves.

In recent years, the Reserve Bank has been happy to report that inflationary expectations are now well anchored at a low level. We have been able to say that, as a result, we expect that smaller adjustments in interest rates will be required to maintain price stability, and of course this is good news. It would be a tragedy if sloppy thinking by price setters, and a return to an indexation mentality, meant that the benefits of those lower inflationary expectations were lost.

The impact of the exchange rate on inflation

The second point I want to reiterate is the relevance of the exchange rate to inflation.

The exchange rate has two effects on the inflation rate. First, there is the more or less immediate impact of movements in the exchange rate on the prices of goods and services which are traded internationally, or which *could* be traded internationally. We know, for example, that when the New Zealand dollar depreciates the New Zealand dollar price of oil goes up, and the price of petrol goes up with it, quite apart from any impact of an increase in the international price of oil measured in US dollars. Similarly, the price of milk goes up, even though milk is not imported, because the New Zealand dollar price of milk on the international market goes up with the depreciation of the New Zealand dollar. These so-called "direct price effects" of a movement in the exchange rate typically affect New Zealand's inflation rate quite quickly, usually within six to 12 months.

We used to think that a 1 per cent depreciation in the exchange rate would produce an increase in the inflation rate of about 0.3 per cent within 12 months as a result of these more or less immediate direct effects. But for some years now, the impact of a change in the exchange rate seems to have produced a much smaller impact on inflation than that, for reasons which are not entirely clear. The same relatively mild impact of exchange rate movements on inflation has been observed in Australia, Canada, and the United Kingdom in recent years.

But whether the impact is as big as we thought it was in the early nineties or as small as it seems to have been more recently, we now recognise that this short-term impact of movements in the exchange rate is not something which always calls for a monetary policy response. This is because the effects of such exchange rate movements on the inflation rate may have come and gone before adjustments in monetary policy can have much *offsetting* effect on the inflation rate.

But again, the Reserve Bank's ability not to react to the temporary inflation movements associated with exchange rate changes depends on whether we New Zealanders accept that the direct price effects of exchange rate depreciation are not matters which justify our seeking compensation through higher incomes. If we collectively seek such compensation, then the Bank is faced not with a one-off price level adjustment but with the potential for *ongoing* upwards pressure on prices. In that event, we would have no alternative than to lean against that by running a somewhat tighter monetary policy than otherwise.

The second way in which the exchange rate is relevant to inflation is through the effect which the exchange rate has on the demand for New Zealand-produced goods and services. When the exchange rate depreciates, goods and services produced in New Zealand become cheaper relative to the price of goods and services produced abroad. Foreigners seek to buy more of the goods and services produced here, and so also do New Zealanders. In other words, our exports become more price-competitive overseas, and domestically-produced goods and services become more price-competitive vis-a-vis imports. Those producing exports and import-substitutes see an increase in their sales. If they are operating at full capacity, they will seek to expand production by increasing investment and hiring more staff.

And this is great – until such time as the demand for additional resources from exporters and those producing import substitutes collides with the demands for resources emanating from the domestic, so-called "non-tradable", parts of the economy. If the total demand for resources is greater than the resources available, then at some point inflation will begin to develop.

So in assessing the appropriate stance of monetary policy, the Reserve Bank can not ignore these indirect effects of the exchange rate on the total demand for New Zealand goods and services. The exchange rate is *always* relevant to assessing the appropriate stance of monetary policy.

Does this mean that the Reserve Bank has some secret exchange rate target, or perhaps some secret exchange rate floor? Does it mean that we might increase interest rates to "prop up" the exchange rate? Absolutely not. It just means, to repeat, that we have to set overnight interest rates in recognition of these medium-term effects of the exchange rate on total demand. If the export sectors, and the sectors supplying import substitutes, were demanding more resources than the domestic sectors of the economy were willing to release, then interest rates would need to rise somewhat to avoid that conflict generating on-going inflation.

Does this mean that the Reserve Bank has resurrected the Monetary Conditions Index (MCI)? Absolutely not again, if by that is meant: are we seeking some semi-automatic movement in interest rates to offset movements in the exchange rate? If the exchange rate moves, either up or down, we always have to try to assess the reasons for that movement. It may be, for example, that a depreciation in the exchange rate reflects actual or potential weakness in international commodity prices which would have a *disinflationary* impact on the economy fully offsetting the inflationary impact of the depreciation, thus requiring no offsetting interest rate increase.

But the exchange rate does affect the demand for New Zealand-made goods and services, and therefore has medium-term implications for the inflation rate. So while we can often ignore the direct and relatively immediate price effects of movements in the exchange rate, assuming that these direct price effects do not generate "second-round" inflation pressures, we can not ignore these medium-term implications.

Monetary policy and the balance of payments deficit

Finally, allow me some observations on the relationship between monetary policy and the balance of payments.

I have often argued that monetary policy has no ability to influence the balance of payments deficit, certainly on any kind of sustainable basis. Indeed, I do not even know whether, if I were instructed to use monetary policy to reduce the deficit (through the Government's using the so-called "over-ride" provision in the legislation), I would be tightening or easing monetary policy. Tightening policy would presumably cause the exchange rate to appreciate, making the deficit larger, but might also slow domestic demand, making the deficit smaller. The problem arises from the fact that no central bank has discovered a reliable technique for changing the *mix* of monetary conditions so that, for example, monetary policy could be tightened through an increase in interest rates without at the same time putting upward pressure on the exchange rate.

I have also argued in the past that, eventually, in a situation where the exchange rate is floating and the government is running a fiscal surplus, the balance of payments deficit would reduce of its own accord. That is based on a recognition that, in those circumstances, a balance of payments deficit reflects the fact that the *private* sector is spending more than its income – or in other words, is a net borrower – and that this situation is unlikely to continue indefinitely. At some point, either New Zealanders will decide to borrow less or foreigners will decide to lend us less. If foreigners tire of lending us their savings before we New Zealanders tire of borrowing them, the likely outcome is a change in the mix of monetary conditions, in the direction of a lower exchange rate and somewhat higher interest rates. We know that such a change in the mix of monetary conditions tends to reduce the balance of payments deficit (and if we had had any doubts on this score they would have been allayed by the speed at which the large balance of payments deficits which some Asian countries had prior to the recent crisis were converted into surpluses).

The concern which I have expressed on previous occasions, however, is about the social and economic costs which might be paid if the change in the mix of monetary conditions takes place too abruptly, as it certainly did in the Asian crisis economies.

It is at least possible, however, that what we have been witnessing in recent months is in fact a gradual change in the mix of monetary conditions of the sort which will, over the next few years, see quite a significant reduction in the balance of payments deficit. Certainly the exchange rate, on any measure, is at an historically low level and is providing strong stimulus to export industries and to those producing import substitutes. Interest rates are not at a particularly high level – indeed, they are well below the levels reached in the mid-eighties and mid-nineties, at least in nominal terms – and I suspect that that may have something to do with the fact that New Zealanders are getting a little less enthusiastic about borrowing at much the same time as foreigners are getting a little less enthusiastic about lending us their savings.

But it is important that we all understand what curing the balance of payments deficit implies.

It implies that for a period of some years those producing exports and import substitutes will enjoy rather stronger levels of growth, in sales and incomes, than those producing goods mainly for the domestic market. In plain English, that means that farmers, export manufacturers, fishing companies, tourist operators, and the like are likely to be relatively prosperous, while those in industries such as construction and retailing may be somewhat less so.

It implies that consumption spending may grow rather more slowly than total disposable income, with the difference going into increased saving.

It implies that interest rates may favour savers rather than borrowers for a period, and that as a consequence household sector borrowing may grow more slowly than household sector income, rather than substantially faster than household sector income, as for the last 15 years.

None of these changes would be good or bad in themselves, though no doubt there would be many who would welcome signs that we New Zealanders have an ability to live within our means.

But they would certainly involve changes which we would all need to be mindful of in interpreting economic indicators. For example, whereas once upon a time the state of the residential building industry was of fundamental importance in assessing the strength of the New Zealand economy, it may well be that over the next few years, as resources are attracted into export and import-competing industries, the residential building industry becomes a little less important in a relative sense. Similarly, the rate at which consumer spending grows may slow somewhat in the years ahead, after a period during which it grew substantially faster than household sector income. At the same time, we may see strong growth in industries, and regions, which have a heavy emphasis on exporting.

Mr Chairman, as you can see, I have been careful to avoid giving even the slightest hint about what the Reserve Bank will be saying in its *Monetary Policy Statement* in two weeks' time. But I have appreciated this opportunity of putting that *Statement* into context, and repeating some of the messages which may have been lost sight of in recent months. Most important of all, the Bank's ability to ignore the "spike" in inflation which seems likely to lie ahead of us depends crucially on the willingness of New Zealanders themselves to ignore that spike in negotiating increases in their own incomes. If they do not, there can not be the slightest doubt that monetary policy will need to be tighter than would otherwise be the case.