Should the Reserve Bank have eased as fast as the Federal Reserve?

An address by Donald T Brash, Governor of the Reserve Bank of New Zealand to the Rotary Club of Auckland on 21 May 2001

Introduction

Over recent days, the Reserve Bank of New Zealand has puzzled a lot of people – indeed even angered a few! – because we have been slower to ease monetary policy than they have expected or wanted, and slower than central banks in some other countries.

Surely, it is argued, the Reserve Bank must be able to see that the world economy has slowed sharply, and monetary policy should be eased.

Surely, it is argued, the Reserve Bank must be able to see that the domestic economy has been sluggish, business and consumer confidence are down, and monetary policy should be eased.

Surely, it is argued, the Reserve Bank must be able to see that the drought has been serious and will have a potentially big impact on production next season, and monetary policy should be eased.

Surely, it is argued, the Reserve Bank must be able to see that the US central bank, the Federal Reserve, has eased policy by much more than has been the case in New Zealand. Given the record of growth with low inflation which the US economy has achieved over the last decade, surely this suggests that the Reserve Bank of New Zealand should be following the Fed's example, and easing monetary policy more aggressively.

Certainly, the American central bank has cut its official interest rate by 250 basis points since the beginning of the year. The Australian central bank has cut its official interest rate by 125 basis points since the beginning of the year. And to date the New Zealand central bank has cut its official interest rate by a rather more modest 75 basis points since the beginning of the year.

And forecasts of the parts of the global economy of most relevance to New Zealand, compiled in London by an organisation called *Consensus Forecasts*, continue to be revised down. Back in November, as we prepared our December *Monetary Policy Statement*, the *Consensus* forecast for the 14 countries of most relevance to us had growth in those countries this year at 3.5 per cent. Three months later, that forecast had been revised down to 2.9 per cent. Now, the forecast is only 2.3 per cent. Surely, it must be obvious to the Reserve Bank that the world economy is going to continue to get weaker, and monetary policy must be eased urgently.

The most important point I want to make to those who run these arguments is that, just because other central banks have eased monetary policy substantially, the Reserve Bank of New Zealand is not necessarily remiss in taking a somewhat different course. Why? Simply because every national economy is unique. Monetary policy is not a race, with every central bank trying to get to the finishing line first. It is about adjusting interest rates to influence demand within a specific economy to ensure price stability in that economy. What is right for one country might well be entirely wrong for another.

So while *of course* it is important that we in New Zealand are aware of what other central banks are doing – because their actions may say something about their economies which could be relevant to inflationary pressures within New Zealand – matching the decisions of other central banks point for point will often make no sense at all.

Should we in New Zealand have been easing monetary policy more quickly than we have been doing? Or in other words, will the slow-down in the world economy reduce inflationary pressures in New Zealand so much that some time in the next year or so inflation will fall towards the bottom of the agreed 0 to 3 per cent target band?

Still plenty of risks in the world economy

It is certainly possible to imagine some very pessimistic scenarios which would warrant a major further easing of interest rates in New Zealand, or indeed make us wish that we had eased more quickly over the last few months. In June 1999, I was one of three central bank governors who gave speeches in answer to the question "Is deflation a risk?" at a seminar held in conjunction with the annual meeting of the Bank for International Settlements in Basel, Switzerland. My task was to sketch out a situation in which the world economy found itself in a situation of generalised deflation. I found it disturbingly easy to do.

Two years later, there are still considerable risks. While the high-tech parts of the US equity market have fallen from stratospheric levels to more moderate levels over the last year, the market capitalisation of the stocks in the S & P 500 index, which reached a peak of 132 per cent of US GDP in March 2000, remains at around 110 per cent of US GDP, compared with an average for that ratio of just 50 per cent over the last 75 years. Or to put the matter differently, the US share market appreciated between 1982 and the year 2000 at a rate five times faster than underlying corporate earnings growth. There is plenty of scope, in other words, for US equity markets to fall much further yet, and US business confidence and consumer spending to fall with them.

Indeed, after by far the longest uninterrupted economic expansion in US history, a fairly marked slowdown in the US economy might not even need the trigger of a further fall in US equity markets.

The Japanese economy continues to experience serious difficulties, its banking and insurance sectors fragile, its public debt very large and increasing, and its immediate prospects clouded.

And inevitably, with the outlook for the American and Japanese economies uncertain, the prospects for the economies of non-Japan Asia are also unclear – with banking sectors still showing the open wounds of the crisis of three years ago and their biggest markets slowing sharply.

The Australian economy, of great importance to our own economy as our largest single trading partner, saw a fall in GDP in the December quarter of last year, while in recent months unemployment has been rising and business confidence falling.

So let me make it quite clear: because of the impact of a slowing world economy on inflation in New Zealand, it may well be necessary to ease monetary policy in New Zealand substantially further than we have done so far. We are as keen to avoid having inflation go below the bottom of our 0 to 3 per cent target as we are to avoid its going above.

But in a situation where the New Zealand economy has recently been operating near to full capacity – with unemployment near a 13 year low, and some measures of capacity utilisation back to levels last seen in the period of strong growth in the mid-nineties – three things have led us to ease policy more slowly than some other central banks have done, and more slowly than some New Zealanders would like.

So far, the world economy continues to grow

First, and despite the slowing which has occurred, the world economy continues to grow. In the United States, growth in GDP in the March quarter was stronger than most observers had expected, and only a few commentators are expecting the US to experience a recession this year. Indeed, many commentators are predicting that the US economy will "bounce back" in the second half of this year, or at least by the fourth quarter. Interestingly, US equity markets, which must be assumed to reflect sentiment about the future of corporate earnings, have recently advanced, and the S & P 500 index is less than 20 per cent below the all-time high it reached in March last year. The narrower Dow index is less than 5 per cent below its all-time high.

In Japan, the prospect of a new political determination to deal with the problems which have beset that economy for more than a decade has improved sentiment, and the Nikkei stock index is well up from the low point reached in the middle of March this year.

In Australia, it has been pointed out that the modest fall in GDP in the fourth quarter was mainly the result of a very sharp fall-off in the construction sector following the introduction of GST in mid-year, with most of the rest of the Australian economy continuing to grow at an annual rate of around 4 per cent.

Although not too much should be made of it at this relatively early stage, *Consensus* forecasts for our 14 major export markets suggest growth next year of 3.6 per cent, well up from the 2.3 per cent expected for the same markets this year.

If we eased policy too much now, and that easing had its biggest effect next year, as we expect, we might find that policy would be stimulating the economy at the very time that the world economy was picking up.

New Zealand's export prices continue to hold up

Secondly, and contrary to much past experience, the slowdown in the world economy which has occurred to date has not had an obviously negative effect on the world prices of many of New Zealand's exports.

Of course, the prices of some exports have been seriously affected. The world price of our seafood exports is well down over the last year for example. But many other prices have held up well, and that has been particularly true of major exports such as meat and dairy products (both up by more than 22 per cent in world price terms in the 12 months to April).

In aggregate, the world price of New Zealand's commodity exports rose almost 14 per cent in the year to April 2001, and almost 23 per cent over the two years to April 2001.[1] This means that an important channel through which weakness in the world economy typically affects New Zealand has so far, on this occasion, been blocked.

The New Zealand dollar is sheltering the economy from foreign chills

Thirdly, as we assess the impact of the relatively subdued world economy on the New Zealand economy, and therefore on New Zealand inflation, we have to assess also the impact which the New Zealand exchange rate is having on the situation. If, as is possible, the world economy slows further, and if, as also seems possible, this has a negative effect on the world price of New Zealand's export commodities, will our export industries, and those industries competing against imports, be protected from those cold winds by a low exchange rate?

Make no mistake. As many of you are aware, the New Zealand dollar is not far above its lowest level ever against the United States dollar, and remains at a very low level also against the Japanese yen and sterling. It is not so low, to be sure, against the Australian dollar and the euro, two other currencies which have been weak in recent times, but weakness against the US dollar, the yen, and sterling is certainly providing strong benefits to many of the companies and individuals operating in export and import-competing industries.

As a consequence, while the world prices of New Zealand's commodity exports have gone up by an already large increase in the 12 months to April (almost 14 per cent), the New Zealand dollar prices of those exports have risen by a very strong 36 per cent over the last year, and by almost 60 per cent over the two years to April.

Initially, the volume of New Zealand's exports of good and services grew rather strongly in response to this stimulus (helped no doubt in part by the return to more normal climatic conditions down on the farm). More recently, export growth has slowed down quite sharply. We don't fully understand why this is so. Perhaps it just takes longer than we might have thought for businesses to gear up to increase exports. Perhaps businesses have been frightened by media stories about the slowing in the world economy. Perhaps businesses were so traumatised by the experience of a strong exchange rate in the mid-nineties that they will respond only cautiously to the apparent enticements offered by the now-low exchange rate. Perhaps other countries with which New Zealand exporters compete in, say, the US market have experienced similar levels of exchange rate depreciation against the US dollar, thus eroding much of the benefit to our exporters of the depreciation of the New Zealand dollar. Perhaps for many of our exporters the Australian market is

[1] ANZ New Zealand Commodity Price Index, 2 May 2001.

still the major market, and here there has been little depreciation over the last few years.

One of the difficult judgements we have had to make in deciding how to run monetary policy in recent months concerns what the low exchange rate means for future inflation pressures. If the economy responds to the low exchange rate as it has in the past, we would expect to see strong growth in net exports over the next year or two, with export and import-competing industries investing in new capacity, hiring more staff, and expanding production. The risk is that such a strong expansion in the export and import-competing industries would put pressure on available resources. That in turn would lead to increased inflation unless monetary policy were kept appropriately tight.

If, on the other hand, the economy does not respond to the low exchange rate as it has in the past, as seems possible on the basis of very recent experience, it may be that export and import-competing industries will expand only moderately. In that situation, monetary policy would not need to be as tight in order to keep inflation under control.

Like it or not, no central bank operating in an open economy can afford to ignore the exchange rate in setting monetary policy. The fact that we have not only not increased the Official Cash Rate despite our currently low exchange rate but have actually felt able to reduce it in recent months largely reflects our assessment of the global economy, and our assessment that, for reasons not yet fully understood, the exchange rate is not providing the stimulus to export and import-competing industries that has been true in the past.

But, as will be obvious, if the economy does start responding to the low exchange rate as it has historically, there will be a need for interest rates to be quite a bit higher than currently, if resources are going to be able to move from domestic parts of the economy to the export and import-competing industries without causing inflation. This is true because, in aggregate, the economy is already operating at close to capacity, with some measures of capacity utilisation back at levels last seen in the boom of the mid-nineties and unemployment at a near 13 year low.

As an aside, the data on employment and job advertisements released 10 days ago on balance support this assessment that there is little spare capacity in the labour market. While it is true that total employment did not increase over the March quarter, wage rates have begun to climb – by a little more than we and the market had been expecting; hours worked rose strongly during the quarter, and are now some 6 per cent above the level in the first quarter of last year; unemployment is at its lowest level since June 1988; and job advertisements, while down slightly for the month of April, remain well ahead of their level at this time last year.

There are clearly strongly conflicting influences on the future path of inflation in New Zealand. It is entirely possible that we will need to ease monetary policy more than we have done to date. It is also entirely possible that we will need to increase interest rates from their present level. In such an environment, it is prudent to adjust policy cautiously as we watch the evolving balance of those influences.

At this stage, we see inflation settling back near the middle of our target range with something close to current interest rate settings. But it is not difficult to imagine outcomes that are rather less benign – in either direction. At the end of the day, monetary policy depends on the outlook for inflation one to two years ahead. At the moment, that in turn depends primarily on how the economies of our trading partners evolve, on the extent to which any global slowdown affects demand for our exports, on how the New Zealand exchange rate behaves, and on how the New Zealand economy responds to the exchange rate.

My plea to observers and commentators is to keep in mind that New Zealand's economy is not the Australian, or the American, or indeed any other economy. In the March *Monetary Policy Statement*, I mentioned that the New Zealand economy was "favourably out of sync" with the rest of the world. Actually, we are often out of sync with the rest of the world, either favourably or unfavourably. New Zealand's economic fortunes depend to a significant extent on a relatively narrow range of exported goods and services, and so we often face relatively sharp slow-downs and, on the flip-side, relatively fast accelerations. That is the nature of our economy. For the Reserve Bank, that inevitably means trying to steer a course through these short-term vicissitudes, a course appropriate to the inflationary pressures in the New Zealand economy, whatever the Federal Reserve and other central banks are doing.