The new inflation target and New Zealanders' expectations about inflation and growth

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Introduction

As perhaps you know, this is the fourth time I have been invited to address the Canterbury Employers' Chamber of Commerce at your first luncheon meeting of the New Year and I want to use the occasion to talk about two issues.

First, I want to talk about the new Policy Targets Agreement signed last month, amending the inflation target from 0 to 2 percent to 0 to 3 percent. And secondly, I want to talk about the expectations which we New Zealanders have about both inflation and economic growth. In some important respects, I believe that those expectations are quite unrealistic.

The new inflation target

First, the new Policy Targets Agreement. There have been two changes made in the new PTA, but I suspect that to the general public the only difference between the new Agreement and all of the earlier ones is that the new Agreement has changed the 'definition' of price stability from 0 to 2 percent to 0 to 3 percent, while making it clear that delivering that price stability remains the single objective of monetary policy and constitutes the best way in which the Reserve Bank can contribute to New Zealand's economic development.

Some will ask in anger why the inflation target is still so low, and why the Bank will continue to focus monetary policy on delivering that target, when there are other objectives - such as economic growth, employment, and export competitiveness - which are at least as important and in many respects more so. Others will feel betrayed that the ceiling of the inflation target has been raised from 2 to 3 percent, or that the mid-point of the target has been raised from 1 percent to 1.5 percent, particularly given the fact that the two largest parties in Parliament were both strong advocates of a mid-point of 1 percent during the last election campaign. I want to try to respond to both groups of critics.

In many ways the easiest critics to respond to are those who feel that the inflation target is still too low, or that, given the extent to which the economy has been slowing in recent months and the extent of the pressures on the export sector, the Bank's objectives should have been widened to include those other objectives. For there is in fact no evidence that monetary policy can, by tolerating a little more inflation, engineer a sustainably higher rate of growth, or a sustainably higher level of employment, or a sustainable improvement in export competitiveness. To be sure, monetary policy can engineer faster growth, higher employment and improved exporter competitiveness in the *short* term - by tolerating a bit more inflation right now, there is not much doubt that growth and employment would be a little higher in 1997 than otherwise, and that exporters would enjoy the benefits of a lower exchange rate. Most of that faster growth and higher employment would be bought at the cost of tricking working New Zealanders into accepting a reduction in their real wages, as prices rose ahead of wages. However, it would not last. Before too long, people would recognise the deception and would demand compensation in the form of higher wages and salaries. Within a very short time, inflation would be rising, growth would be back to its previous, lower, level and we would be left contemplating the cost of reducing inflation again - and nobody should forget the very substantial one-off costs, in terms of unemployment and lost output, incurred in reducing inflation from levels above 15 percent in the mid-eighties to our current situation of price stability in the early and mid-nineties.

Not only is there no evidence that tolerating more inflation can engineer sustainably faster real growth, there is now overwhelming evidence that high inflation positively *damages* the way in which the economy works - reduces the capacity for sustainable growth and higher employment, and of course also does huge social damage, through the arbitrary redistribution of income and wealth which it creates.

There is also very considerable evidence that even quite low rates of inflation do damage to growth and employment, and virtually no evidence that inflation actually helps those objectives. This is why the second of the two changes in the Policy Targets Agreement makes clear that it is precisely in order to *enable* monetary policy to make its maximum contribution to sustainable 'growth, employment and development opportunities' that the Bank is directed to focus on maintaining a stable general level of prices.

But isn't there some concern, fostered in the popular media by the American economist Paul Krugman, that if inflation is *too* low it may actually damage growth? In other words, even if we accept that high or even moderate inflation is damaging, isn't it possible that central banks which are excessively obsessive about achieving *no* inflation might actually be harming the economy and the society they claim to be helping?

This brings me to the second group of critics, who are concerned that in changing from 0 to 2 percent to 0 to 3 percent we have betrayed the intention of the Reserve Bank Act, requiring that monetary policy focus exclusively on delivering 'stability in the general level of prices'.

There is quite intense debate going on at the moment around the world among central bankers and academic economists about what the best specification of a low inflation target should be. There are two broad schools.

The first school accepts that monetary policy should be focused on delivering predictably low inflation but argues that for several reasons that target is best expressed as inflation in a range of 1 to 3 percent. The best known advocate of this 'low positive inflation' school is probably Stanley Fischer, formerly of MIT and now Senior Deputy Managing Director of the International Monetary Fund. He is visiting New Zealand next month, and it is likely that his views will receive appropriately wide media coverage at that time. He argues for this 'low positive' inflation target for various reasons, of which three are particularly important:

- The way in which inflation is measured results in quite a significant over-statement of actual inflation. Estimates of this over-statement in the United States have suggested that, in that country, the 'bias' in the measurement of inflation is between 0.7 and 2.0 percent, with bias of 1.1 percent very recently estimated by a group chaired by Michael Boskin on behalf of the United States Senate Finance Committee. For this reason, central banks should target *measured* inflation of at least 1 percent, because to target anything lower than that would be to target *de facto* deflation.

- Because at some stage in the cycles through which all economies go it may be necessary in the interests of maintaining a high level of employment for there to be some reduction in inflation-adjusted (or real) wages, having a low positive level of inflation is more desirable than having absolutely no inflation. This is because, with some inflation, real wages can be slightly reduced by simply giving no *increase* in nominal wages, whereas with no inflation reducing real wages involves having to actually reduce nominal wages. Real wages can still be reduced, even with no inflation, but only at the expense of higher unemployment.

- Similarly, it is argued that at some stage in the economic cycle it may be desirable for inflation-adjusted interest rates to fall below zero to provide a strong stimulus to demand and, since it is not generally practical for nominal interest rates to fall below zero, it is helpful if inflation is some low positive number to make negative real interest rates possible.

The second school of thought argues for a lower inflation target, often characterised by 0 to 2 percent but sometimes expressed as the *level* of average prices remaining stable over time. Those who favour this view discount the arguments advanced by the 'low positive' school. They acknowledge that there is an upward bias in the way in which inflation is measured, but argue that in most countries outside the United States that bias is almost certainly less than 1 percent and certainly could not justify a target with a mid-point of 2 percent. (The New Zealand Government Statistician is strongly convinced that there is less bias in the measurement of the New Zealand CPI than there is in the measurement of the US CPI.) They acknowledge that it has not been easy to adjust nominal wages downwards in recent years, but argue that in substantial part that is a result of the persistently high inflation most countries have experienced in recent decades, so that that should be no more than a transitional problem. Moreover, even though it may be difficult to reduce the wages of an individual employee, that does not prevent significant reduction in unit labour costs as a result both of unchanged wages and positive productivity, and of natural turnover in the labour force. Critics of the 'low positive' school challenge the assertion that monetary policy occasionally needs to reduce real interest rates below zero, and note other ways in which monetary policy can stimulate demand, particularly in very open economies where movements in the exchange rate play an important role in influencing aggregate demand in the short term.

Those favouring very low inflation (0 to 2 percent) argue that not only are there no *advantages* in tolerating a 'low positive' rate of inflation there are also significant *disadvantages* of even quite low rates of inflation. Thus for example Martin Feldstein of Harvard University (and current president of the National Bureau of Economic Research in the US) argues strongly that even very low levels of inflation significantly exacerbate the biases in the tax system which encourage consumption, discourage saving, and encourage excessive investment in residential property. In a recent paper he argued that reducing measured inflation from 3 percent to 1 percent in the United States would result in a *permanent* increase in the level of US GDP of 1 percent, a very large gain in economic well-being even if there is some temporary loss of output required to reduce inflation to that level. Others have also argued that the interaction between inflation on the one hand and tax and financial reporting systems geared to historical cost accounting on the other creates a significant bias against capital-intensive investment projects and all investment with a long pay-back period, and a bias in favour of highly-geared companies and investments with a short pay-back period.

This debate is by no means concluded. At a major conference I attended last August in the United States, it seemed to me that a majority of those who expressed an opinion favoured a 0 to 2 percent target, and that has been my own clear predilection. But given that there are very experienced central bankers and monetary economists in both schools, it is at this stage quite inappropriate to be dogmatic, and in my own view a target which involves doing our utmost to keep measured inflation between 0 and 3 percent is certainly consistent with the intention of the legislation within which monetary policy is operated.

Indeed, irrespective of where the mid-point of the target range should be, there may be some advantage in having a slightly wider inflation target than the original 0 to 2 percent target. A number of observers have suggested that a target with a width of only 2 percentage points requires an excessive degree of activism on the part of the central bank, and that a slightly wider band, whatever its mid-point, would be sensible. This has been argued, for example, by David Turner, an OECD economist. The tension is between, on the one hand, choosing a target range which effectively anchors inflation expectations at a low level but which is so narrow that it provokes excessive policy activism and risks loss of credibility by being frequently exceeded; and on the other, a target range which does a less effective job of anchoring inflation expectations, but which requires less policy activism and protects credibility by being rarely breached. A 0 to 3 percent range seems a reasonable compromise.

But whether there is any benefit at all from a wider target band depends significantly on how a wider band, with a higher 'ceiling', affects the public's expectations of future inflation. If people understand the new target as meaning that the Bank, under Government instructions, is now willing to accept 1 percent more inflation than previously, then nothing positive will have been achieved at all - and indeed there will almost certainly be net cost involved in the change. This is because any increase in inflationary expectations would tend to feed into slightly higher pricing decisions, slightly higher wage settlements, slightly greater eagerness to borrow, slightly less enthusiasm for saving. If the Bank were willing to accept this behaviour, 'accommodate' it in the jargon, we would end up with somewhat higher inflation but no other result (though of course the higher inflation would have all the negative consequences for the real economy referred to earlier). If the Bank were in fact *not* prepared to accommodate this increase in inflationary expectations - which it would not be, I hasten to emphasise - then the end result of increased inflationary expectations would simply be higher real interest rates, somewhat lower economic growth, and somewhat higher unemployment. If that were the end result, the widening of the inflation target would not only provide no benefit; it would be positively damaging.

So I think it is crucially important that nobody misunderstand what the Reserve Bank is doing. Let me be absolutely clear. The Reserve Bank has not gone soft on inflation. We will not be targeting an inflation rate of 3 percent, or even an inflation rate close to 3 percent. The Reserve Bank will be striving to keep inflation well inside the 0 to 3 percent range, and we best do that by trying to have inflation as close to the middle part of the range as possible.

That does not mean, of course, that we will always hit the target, any more than we always hit 0 to 2 percent. But it does mean that we will be constantly implementing monetary policy with the intention of having inflation as defined around the middle part of the target. If we do this, the number of occasions on which we miss the target should be minimised. Indeed, given the wider target range, there should be fewer breaches than in the past.

Inflation and growth expectations

And this leads naturally into the second major theme of my address today, about New Zealanders' expectations about inflation and growth. It is my contention that expectations about both need to become a lot more realistic.

First, let's look at expectations of inflation. Yes, there are some encouraging signs that New Zealanders' expectations of future inflation have fallen substantially over the last decade as actual inflation has fallen. Surveys of inflation expectations currently suggest that, on average, householders now expect year-ahead inflation to be around 3.9 percent, well down on the levels of the late eighties (year-ahead inflation expectations were 12.5 percent on average towards the end of 1987, and were still 8.3 percent near the end of 1989), while 10-year bond yields are slightly lower than 10-year bond yields in Australia and less than 1 percent higher than 10-year yields in the US. Wage settlements in recent years have also been one of the areas where inflation expectations seem to have been subdued, with a great many wage settlements concluded at levels which have, until recently at least, put little upward pressure on prices.

However, other indications are not nearly as encouraging and suggest that New Zealanders' inflation expectations are still showing the effects of the two decades of high inflation we endured in the seventies and eighties.

Look at New Zealanders' saving behaviour for example. Among those with financial assets, how many are locking in the high real interest rates they purport to see by investing in long-term fixed interest instruments, such as term bank deposits or government bonds? The short answer is 'very few'. To be sure, our bond yields are now comparable to international bond yields, and I used to deduce from that that the new monetary policy framework had produced a profound reduction in inflationary expectations. I now believe that I was unjustifiably optimistic, because it is *foreign* savers who have bought our bonds in huge volumes, thereby reducing bond yields to international levels. More than half the New Zealand government bonds on issue are now held overseas, and the proportion of some of the longer-dated bonds held overseas is even higher. (In recent months, for example, more than 70 percent of the longest-dated nominal bond held by the market has been held by overseas investors.) If we look at the term structure of the New Zealand-sourced deposits of any major bank, we will see that overwhelmingly New Zealanders are holding their cash and fixed interest investments at very short term, the great bulk with a maturity of less than 12 months. Indeed, most banks have close to 90 percent of their total deposits maturing within six months, and very few have more than 5 percent of their deposits maturing beyond 12 months. By and large, most New Zealanders do not invest their savings in long-term fixed interest securities at all, despite what are, on the face of it, very attractive inflation-adjusted interest rates.

What *are* we doing with our savings? Though the data on saving behaviour in New Zealand is not very good, anecdotal evidence strongly suggests that New Zealanders invest any available saving in some form of equity investment, most typically property: a bigger house to live in, another house to rent out, a bigger farm, another piece of farmland, perhaps a block of flats, a beach-side section, an industrial property, a commercial building, perhaps a forest block, *anything* which, the best-selling books and advertisements constantly tell us, will protect us against inflation. Protect us against inflation? But we've hardly *had* any inflation for the last six years and, despite the biggest change in New Zealand's constitutional arrangements this century, we have just had the new Coalition Government re-affirm the strong commitment to price stability. True, but we've certainly had two decades of high inflation in the memory of all adult New Zealanders and we all know of people who lost most of their life's savings over that period by 'making the mistake' of investing in 'secure' fixed-interest investments.

I've told the true story of my uncle so many times that I am almost embarrassed to tell it again, but in my view it contains the explanation of much of the current approach to saving in New Zealand, so I will tell it again. After a life-time of orcharding in the Nelson area, he sold his orchard in 1971 and invested the sale proceeds 'safely' to provide income and security for his retirement. To be absolutely safe, he invested the entire proceeds in 18-year government stock, at the then-interest rate of 5.4 percent. Perhaps fortunately, he did not live until those bonds matured in 1989, but if he had done the $30,000 he received from selling his orchard in 1971 and which matured in 1989 would have bought him by that time just one Toyota Corolla car (with a little change). In 1971, $30,000 would have bought him 11 Toyota Corollas. In the space of just 18 years, he had lost some 90 percent of his retirement nest egg, all by making the mistake of assuming that inflation would stay at the relatively low level of 1971.

As I say, most adult New Zealanders know stories similar to that one. Or they know stories which tell the same message in another way. Stories about people who bought a property with borrowed money in the early seventies and watched the price of the house increase perhaps eight- or ten-fold over the next 20 years, with the value of the equity actually invested in the house (after allowing for the money borrowed to help finance the purchase) increasing perhaps 30 times. Perhaps we have had an experience like that ourselves. Even if we have not, we are assailed by books and advertisements on all sides which assure us that property investment is the best way of 'protecting you against inflation', to say nothing of making the most effective use of the tax system. Even if we are not familiar with the detail of the statistics, we know that in recent years residential property prices have risen hugely in much of the country, most obviously in Auckland. According to REINZ data, the median price of house sales in the Auckland district rose by 53 percent over the three years to December 1996, by 36 percent in the Southland district (including Queenstown), and by 29 percent in the Waikato/Bay of Plenty district. Even rural land prices, which have come back markedly in some areas in recent months, rose by 45 percent over the three years to the first half of 1996, according to Valuation New Zealand data. Is it any wonder therefore that New Zealanders who claim to believe that *consumer* price inflation is more or less under control continue to borrow money enthusiastically at 9, 10, and 11 percent to acquire property?

Lest there be any misunderstanding, I am assuredly not against investing in property, let alone against home ownership. I own a home and a small amount of other property myself. I am merely saying that inflationary expectations are alive and well in the minds of most New Zealanders and that, until that situation changes, we will inevitably be looking at interest rates which look high in comparison to current consumer price inflation. Conversely, of course, as inflationary expectations abate, and particularly as expectations of property price inflation abate, the overall level of interest rates will tend to be lower also.

Alan Greenspan, chairman of the US central bank, has on several occasions suggested that price stability obtains when economic agents - businesses and private individuals - no longer take account of the prospective change in the general price level in their economic decision-making. It is clear that we still have a little way to go.

What about New Zealanders' expectations for economic growth? Are these too quite unrealistic? I believe that they are, at least based on current policies and attitudes.

In the early nineties, New Zealand achieved real economic growth of more than 5 percent per annum for two years in succession. We were told that we were growing faster than any other OECD economy, and at growth rates comparable to those achieved by the East Asian 'tiger' economies. We began to believe that, as a result of the economic reforms of the last decade, we too were capable of 5 or 6 percent growth indefinitely and all of us wanted to believe that. Sadly, we can not, or at least there is no evidence yet that we can. The very fast growth of 1993 and 1994 was the result in part of the one-off productivity gains resulting from the micro-economic reforms of the late eighties and early nineties, and in greater part of the economy having available a large number of unemployed and underemployed people, and unutilised industrial capacity, as a result of the recession of 1991 and early 1992. As these people and this capacity were brought back into productive work, the rate of growth of real output jumped well above its sustainable rate. The rate of unemployment fell very sharply from almost 11 percent to just over 6 percent in little more than three years and, while everybody hopes that unemployment falls further, it is clearly impossible to reduce the rate of unemployment by 5 percentage points every three years indefinitely.

As I told the members of the Auckland Chamber last year, economic growth depends primarily not on monetary policy but on real factors - on how fast the labour force is growing, on how skilled the labour force is, on how much capital that labour force has to work with, on the technology embodied in the capital, on the efficiency of the price system in signalling where capital can be most productively invested, on the nature of regulations and restrictions which inhibit the effective working of the price system, and a host of other factors. Prices which are, on average, stable assist the pricing system to work effectively, and thereby help to ensure that investment takes place in the most economically sensible places. Prices which are, on average, stable tend to encourage saving, and thereby help to finance additional investment. But stable prices won't make the labour force grow more quickly, or make the labour force more skilled, or improve the technology embodied in the capital equipment which the labour force uses; let alone make public sector enterprises more efficient; or improve the quality of the education system; or move resources out of highly protected sectors into those which can be competitive on international markets; or improve the marketing of commodity exports; or even give us East-Asian-type savings rates.

I would argue strongly that price stability has been helpful to the improved performance of the New Zealand economy in recent years, but I have never claimed for a moment that price stability has been the sole reason for our better performance, nor that price stability guarantees us strong growth in the future. In addition to our ability to bring back into productive work people and capital equipment that had become unemployed during the recession, our very much improved growth performance in recent years has been the result of a whole range of policy changes - of reduced protection and regulation in the private sector, of corporatisation and privatisation of many formerly inefficient public sector enterprises, of a vastly less distorting tax structure, of port reform, of labour market reform, and all the rest.

If we want to build on that achievement in the years ahead, we must constantly be seeking areas where productivity can be further improved. At this stage, the aggregate numbers for the economy as a whole have led the Reserve Bank to base its economic projections on trend labour productivity growth of no more than 1.25 percent per annum. If that turns out to be the case (and 1.25 percent is close to productivity growth in other mature economies, such as the United States[1] and Australia), total growth in GDP could well be around 3 percent per annum because of growth in the labour force. But growth in real income *per head*, which must surely be the real objective of economic policy, will not exceed 1.25 percent annually. If we want faster growth in spending than that, we can in the short term borrow to supplement our income but, as

1 Indeed, over the period from the fourth quarter of 1992 to the second quarter of 1996 overall business sector productivity in the United States grew by only 0.3 percent per annum.

we learned in the seventies and eighties, that is ultimately futile. In the longer term, higher incomes per head, and the higher spending that that can bring, can only come from finding ways to accelerate productivity growth.

And how do we do that? Certainly not by debasing the currency through tolerating inflation. The very rapid growth of the countries of East Asia is in part simply the result of their being able to pick up ‘off the shelf’ modern technologies, which have taken decades to develop elsewhere. In other words, there is a substantial element of ‘catch-up’ in the fast growth of East Asia. But the growth which has occasioned so much envy on the part of some New Zealanders has also been achieved in a particular cultural environment - a cultural environment which places enormous emphasis on family self-reliance, which abjures reliance on the state, which as a consequence generates a savings rate roughly double the New Zealand rate, which pursues education and training with a passion, which regards material affluence as a highly desirable goal. New Zealanders have, implicitly at least, *chosen* a slower growth path, by placing little emphasis on saving, by placing a more modest value on education and training, by valuing other goals more highly than affluence.

I recall seeing a television programme three or four years ago about Asian students in our schools. The programme included comments from two New Zealand children that they resented the fact that the Asian children worked much harder than they did. I don’t think New Zealand children should be forced to work as hard as Asian children do, but I think it is important for our children to realise that they live in a world where those who work hard will end up with higher incomes and more wealth than those who choose to work less hard. If we are only prepared to pay for beer, we won’t be drinking a lot of champagne. The sooner we acknowledge that reality the better for all concerned. By not doing so, the risk is not only that private spending will constantly be running up against income constraints, but also that successive governments will be under considerable and unreasonable pressure to satisfy demands for increased public expenditure. Both will have serious implications for our ability to finance development from our own savings.

Conclusion

Mr Chairman, let me conclude by summarising my main points.

First, I am confident that the new inflation target set me by Government is consistent with the legislation under which the Bank operates and consistent with monetary policy continuing to make the best contribution of which it is capable to New Zealand society and the development of the New Zealand economy.

Secondly, whether the slightly wider target band enables the economy to operate with slightly less central bank activism depends heavily on how the change affects the expectations which people have of future inflation. If people assume that, on average, inflation will be 1 percent higher than they assumed previously, there is a real danger that, far from providing additional flexibility, the wider target will actually harm the way in which the economy works. Let it be clearly understood, therefore, that the Bank will be implementing monetary policy with the intention of having inflation as defined in my agreement with the Minister around the middle part of the 0 to 3 percent target. If we do this, the number of occasions on which we miss the target should be minimised. It would clearly be very damaging if the impression were created that we might be content with inflation outcomes near the top of the target.

Thirdly, we still have some work to do in convincing New Zealanders that our money is a predictably safe store of value for the relevant future. Until that is achieved, the interest rate at which the willingness to save in the form of financial assets is matched by the willingness to borrow will continue to look high by international standards, and our companies will continue to seek unrealistically high rates of return on investment projects. That will tend to mean that investment is lower than it might otherwise be, and that the exchange rate will be higher than otherwise.

Fourthly, it is important that, while constantly aspiring to improve our national growth performance, we all have realistic expectations about the speed at which the New Zealand economy can actually grow. Recent reforms have undoubtedly increased our sustainable growth rate above that which was possible in the past: after several decades of growing much more slowly than other developed economies, we now seem capable of growth comparable to, and probably a little higher than, growth in many other mature economies, such as the United States and the United Kingdom. But we will probably never be able to equal the growth rates achieved recently by the ‘catch-up economies’, while growing faster than we currently can will depend not on the central bank being a little more tolerant of inflation but on continuing improvement in many other policy areas and on sustained productivity growth.

The Reserve Bank makes its greatest contribution to New Zealand society by achieving and maintaining public confidence in the stability of the unit of value, predictably, dependably, reliably.

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