

Alan Bollard: The evolution of monetary policy

Speech by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, to the Rotary Club of Wellington, Wellington, 25 November 2002.

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As a new central bank governor, what I would like to do first is to give you an overall perspective on the role of the Reserve Bank in the New Zealand economy. I will then focus in on the role of monetary policy, and the implications of the new Policy Targets Agreement, and conclude by discussing how all this relates to achieving strong and sustained economic growth.

Monetary policy formulation is a key function of the Reserve Bank, and it is often in the news. But the public attention obscures the other important tasks that the Reserve Bank undertakes. In the hubbub, the fact that monetary policy is part of a larger picture is often lost. The *overall* purpose of the Bank, as I see it, is to maintain the stability and efficiency of the New Zealand financial system.

By the financial system, I mean the tools with which New Zealanders make transactions with each other and with the rest of the world. For very simple transactions, New Zealanders use notes and coins issued by the Reserve Bank. As you may know, nowadays our bank notes are made out of a polymer material that lasts much longer than in the days of paper money. This reduces the Reserve Bank's costs. A side effect is that you'll be seeing Dr Brash's signature around the place for a while yet. Polymer notes are also very difficult to forge, because of their modern security features. That relates to our goal of an efficient financial system. A banknote that is easy to forge would make transactions difficult. Imagine having to check every twenty dollar note that came out of an EFTPOS machine.

Of course, nowadays most significant payments are made using electronic means of transferring funds provided by the financial system. These are much cheaper, faster, and more secure than using large volumes of cash, particularly over long distances. The financial system also facilitates transactions that involve borrowing and lending. For example, individuals accumulate savings in our financial system, and invest those savings in assets like shares and term deposits. These funds then often find their way to New Zealand corporations and households, and are used to build New Zealand's infrastructure. Typically, the individual investor receives a return on those investments, and is able later on to draw on the originally invested funds.

We often take this system for granted, yet its smooth operation is essential to the wellbeing of the New Zealand economy. Banks play a key role in directing funds from individuals who wish to save to individuals who wish to borrow. The system works because people have confidence that funds deposited in banks will be available to them in the future, and that those funds will retain their buying power through time. The Reserve Bank has a central role in providing the regulatory framework for institutions that wish to describe themselves as "banks". We register banks and we monitor their compliance with a comprehensive financial disclosure regime, required minimum capital adequacy ratios, and limits on the loans they can make to related parties. Our framework emphasises the role of bank directors in ensuring that banks effectively manage their risks, and on the role of the market in strengthening incentives for prudent management. This helps to promote a sound banking system.

However, no banking system is without risk. Depositors still need to make their decisions carefully. Banks in New Zealand are not guaranteed by the Government or the Reserve Bank. There is no mandatory deposit insurance in New Zealand.

I mentioned that an efficient financial system needs to have mechanisms by which money can be stored. This is so people can access their money when they need it, without their savings having eroded in value. Ensuring that money holds its value is the primary purpose of monetary policy. Indeed, by statute the Governor of the Reserve Bank is required to use monetary policy to keep the buying power of the New Zealand dollar broadly stable over time.

Maintaining price stability does not mean keeping the price of each and every item the same. I am charged to maintain a stable *overall* level of prices, but individual prices are always changing. Some things, like computers, will probably continue to get cheaper, while some other things may continue to get more expensive, like Martinborough Pinot Noir. But the overall buying power of people's savings is intended to remain broadly constant over time. In the current Policy Targets Agreement, I am specifically directed to attempt to achieve trend inflation outcomes between 1 and 3 percent.

Why is this the primary objective of monetary policy? Both economic theory and hard experience suggests that money holding its value over time helps an economy achieving its potential. Stable money is not a silver bullet, and on its own it can achieve little. However, stable money is one of the building blocks of a successful economy.

Yes, I could use monetary policy to engineer temporary economic growth. By lowering interest rates I could encourage people to borrow and spend for a period. As firms saw increased demand for their products, they would seek to expand output to meet that demand. They would invest in new capital and hire more workers, and this would create even more demand in the economy.

At first this would look like a virtuous circle, one which could lead to an extended period of economic growth. The problem is that lowering interest rates for a period can not create out of thin air the resources needed for growth. Firms that tried to employ more labour and buy more capital goods would quickly run into shortages. That would lead to cost increases for them, and also lead them to put prices up themselves. Eventually, rising costs would make people realise that their increased activity was not profitable. Then the boom would turn into a bust, and firms would be forced to retrench.

Moreover, during the boom period, inflation would rise beyond the price stability target, and the perverse incentives that inflation causes in investment and planning decisions would begin to weaken the economy. To be sure, if I allowed inflation to climb to just 4 or 5 per cent, the effect would be more subtle than the damage done when we had much higher inflation back in the 1970s and 1980s. But 4 to 5 per cent inflation would add nothing to New Zealand's enduring growth rate and it might well trigger a larger inflation problem later on. So I have committed to deliver a trend rate of inflation consistent with the 1 to 3 percent range in the new Policy Targets Agreement. In other words, I plan to deliver a similar inflation rate to the one New Zealand has seen over the last decade.

But it is also important to make clear that monetary policy in the 21st century involves more than just fighting inflation. I've described our over-arching goal as maintaining the stability and efficiency of the New Zealand financial system. Thus, the Reserve Bank cannot afford to be, in the words of Bank of England Governor Eddie George, "Inflation nutters". We are not permitted to cure the patient by killing it.

Let me explain how flexible monetary policy avoids such a result. By its nature, the New Zealand economy is often hit by economic disturbances - for example, changing conditions in the world economy, El Nino and La Nina periods in the weather and fluctuations in the number of people moving to and from New Zealand. All these things can have major impacts on the New Zealand business cycle. They frequently also have consequences for the inflation rate, which are sometimes temporary in nature. One example likely to have only a temporary effect is a drought, which in the short term typically pushes up the prices of agricultural products like fruit and vegetables, generating inflation. However, increases in the prices of things like fresh fruit and vegetables generally would not be seen by the public as the start of a general inflation problem. So it is unlikely that the inflationary consequences of this sort of disturbance would be long lasting. That is particularly true because overall spending in the economy would be reduced by a drought, because farm incomes would be down. So if monetary policy is excessively focused on price stability and we attempt to stop inflation caused by temporary climatic shocks, we could end up exacerbating a recession. By contrast, a policy which looks through short-term inflation fluctuations is much less disruptive to the real economy, and, of course, that's what we do.

In addition, the challenges that central banks face change over time. Look at other developed countries over the past decade or so. Having successfully eliminated the inflation problems of the 1970s and 1980s, central banks could be forgiven for expecting the late 1990s and this decade to be an easy ride. In reality, many central banks face arguably greater challenges. For example, in Japan, despite interest rates falling to very near zero, weakness in private sector demand has persisted for the best part of a decade. Monetary policy in Japan has been unable to prevent deflation - that is, persistent falls in the overall level of prices.

In the United States, the challenge has been running monetary policy in a period where many people believed the economy was moving through a technological revolution that would lead to a prolonged inflation-free, economic boom. That belief translated into very high asset prices, which helped to underpin a long period of strong consumption and investment spending. A key question policy makers faced was whether the asset prices represented fair value, or were a bubble that reflected a collective over-optimism about the future.

Finally, many central banks, including New Zealand, have struggled with the consequences of volatile nominal exchange rates. For example, both the Norwegian and British currencies have persisted at high levels which have been very tough for their exporters. There has been little scope for monetary policy in those countries to solve this problem without generating inflation that would be equally damaging to their exporters.

In my view New Zealand is not about to undergo any of these scenarios. But the world that we face now has moved on from the world of 1989, when the Reserve Bank Act was passed into law. Maintaining price stability, as I am required to do, is different from firstly having to achieve it, as was required then. As you know, before becoming Governor, I signed a new Policy Targets Agreement with the Minister of Finance. This new agreement offers monetary policy a bit more scope to take evolving circumstances into account. In particular, the new agreement makes clearer that the Reserve Bank should maintain price stability in a flexible way that does not unnecessarily disrupt the real economy.

The key change in the agreement is that the inflation target has been explicitly defined in terms of "future inflation ... on average over the medium term". This implies that monetary policy should be forward-looking, and avoid getting distracted by transitory fluctuations in the inflation rate. In typical circumstances, we expect to give most attention to the outlook for CPI inflation over the next three or so years. If the outlook for trend inflation over that period is inconsistent with the target, we will adjust the Official Cash Rate. Our intention will be that projected inflation will be comfortably within the target range in the latter half of the three year period. This means we will set policy so that inflation will be within the target range in the medium term, unless we are hit by a major surprise event. If a major surprise does occur, we will explain what has caused inflation to be higher or lower than we wanted, and what steps we will take to ensure that it goes back comfortably within the band.

I said the new Policy Targets Agreement offers us a little more flexibility, but it's a flexibility that needs to be applied with care. The language of the new agreement makes clear that inflation should not be *persistently* outside either end of the band. This is because a sustained breach of the target could affect people's perceptions of the trend inflation rate. That in itself could create a major inflationary problem. Thus, if one of the disturbances I mentioned earlier appeared to be strongly stimulating or weakening activity in New Zealand - suppose there was a sharp and persistent increase in tourist numbers for example - then the inflationary consequences might not be transitory. So, to keep inflation from rising and activity from going through a boom-bust cycle, monetary policy still needs to act to counteract the impact of these disturbances. And monetary policy still needs to respond particularly assertively when inflation is expected to be well outside the target range, or persistently outside it. But, at other times, if inflation is fairly stable and if we do not see pressures that have the potential to get out of control, then we have a mandate to be a little more flexible in our response.

Is this increased flexibility justified? In other words, can we be a little more flexible than in the past without taking risks with price stability? I think we can, because keeping prices stable gets easier when prices have already been stable over an extended period. If inflation suddenly rises just after a period, like in the 1980s, when it was out of control, then there is a risk it will spark a self-fulfilling belief that it is out of control once again. In other words, if people believe that inflation is out of the bag, they may translate that into higher prices for the goods and services that they sell and higher demands for increased salaries and wages.

By contrast, after inflation has been low and stable for a long time, people are much less likely to see price fluctuations as the start of something serious. Then a self-fulfilling prophecy is much less likely. Our freedom to be more flexible without compromising our price stability goal is thus a consequence of the hard-won achievement, during my predecessor's tenure, of an environment where prices are *expected* to be broadly stable over time. In operating monetary policy, we will continue to carefully monitor people's perceptions of the inflation outlook, to confirm that their confidence in price stability remains strong.

What then of New Zealand's current economic situation? As you know, the New Zealand economy has been going through a strong period, stimulated by international conditions favourable for us. We have had record tourist numbers, and excellent returns on dairy products and many other agricultural commodities. We've also had a very quick turnaround from a net outflow of migrants a year or so ago to a very strong net inflow, which has more than doubled New Zealand's population growth. In combination, these factors have led to pressure on New Zealand's resources. For example, many firms have seen strong demand for their products. This particularly applies to firms in sectors like

retailing and construction that supply New Zealand households. When they've tried to expand to meet that demand, employers have reported difficulty finding additional staff.

This tends to create pressure on prices, and indeed, at present, inflation is near our price stability ceiling. But we run policy looking forward, and it has not been clear how long the effects of that offshore stimulus will last. In the United States the long expansion has given way to recession, and the recovery from that recession appears to have faltered. The Australian economy is experiencing the effects of a drought and, like us, deteriorating trading conditions offshore.

Moreover, the New Zealand dollar has been rising off the low levels seen a year or so ago. For these reasons, over the next couple of years we expect economic growth in New Zealand to slow from its present high rate. We expect that this will constrain much of the inflationary pressure that we see now in some sectors of the economy. At the same time, the rising dollar means that New Zealand dollar prices of imports have fallen. As a result, we expect New Zealand's overall inflation rate to slow quite quickly over the next year.

In terms of monetary policy, in this situation I see good grounds for waiting and seeing how things evolve. Interest rates are at a level in New Zealand where, in our view, they are not significantly stimulating or restraining the economy. If the world economy picks up and the New Zealand expansion continues, we will probably need more contractionary policy settings during 2003. On the other hand, further deterioration offshore and signs that it is catching up with New Zealand could require stimulatory monetary policy settings. So we are keeping our options open.

Finally, let's go back to the broader context for the Reserve Bank's task. I have described how the Bank is focused on helping deliver a stable and efficient financial system to the New Zealand public, and how low and stable inflation is an important part of that. I have suggested that doing this contributes to sustainable and balanced economic development. I've also said that price stability is a contribution but not a solution to the economic challenge facing New Zealand.

How do I see this challenge? Recall that New Zealand's standard of living, as measured by GDP per capita, barely improved at all between 1975 and the early 1990s. It is only in the last decade or so that the New Zealand economy has managed to achieve a sustained lift in growth. The projections I released last week suggest that this growth will continue, but not at a pace sufficient to close the gap that has developed between our GDP per capita and the OECD average.

To do that, over the next 20 years our rate of growth in GDP per capita would have to rise from 2.2 per cent over the last decade to almost 3 per cent over the following twenty years. That's presuming the rest of the OECD grows at the same rate as in the last decade. Achieving this sort of productivity improvement is a worthy challenge. It is only by meeting that challenge that we will get more of the things we need: greater after tax income, improving standards of health care, education, and environmental protection, and faster and faster boats to keep defending the America's Cup.

I hope I have made clear today that the Reserve Bank will be working to achieve continued price stability without standing in the way of sustainable economic growth. Indeed, I think sound, flexible monetary policy contributes to the strong, balanced economic growth that, we all agree, New Zealand needs.