Alan Bollard: Agriculture, monetary policy and the economy

Speech by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, to Federated Farmers, Nelson, 18 July 2006.

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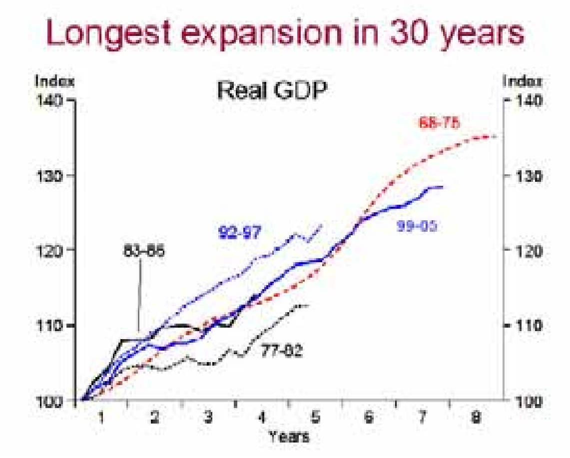
The experience of the last decade has been that agricultural prices and agricultural production remain as important as ever to the New Zealand economy.

Ten years ago we expected to see an economy evolving with a gradually diminishing relative role for primary production, fewer tonnes of produce, more specialised value added, less growth in labour and more value added. Some of this has happened. But we have also seen growth in volume of exports and more labour participation. And we still see a direct relation between the health of primary production and the health of the New Zealand economy.

We have been through huge technological changes signalled by the birth of the internet. But at the same time the renewed vigour of globalisation has brought some old-fashioned features - a big increase in emerging market economies' appetite for resources on the one hand; and fewer obstacles to getting their manufactured goods to first world markets, on the other. At a time when the future of the Doha Round looks so fragile, it is ironic to see the gains we are getting from past improvements in global connectedness. Related to this has been a strong supply of cheap capital into the world's financial markets.

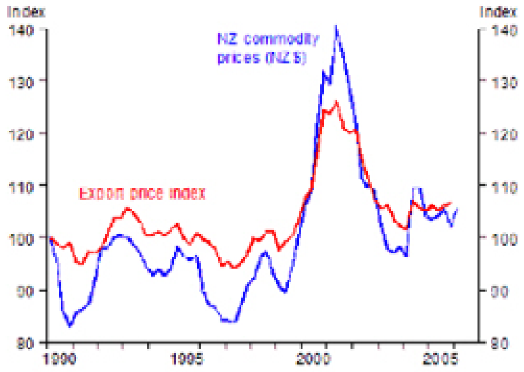
The New Zealand economy has been through a long period of expansion since 1999, probably the second longest period of continuing growth since World War II.



Source: RBNZ.

When we look for the causes of this we see two main factors. First, much of the world has also been through a strong period of growth (despite some emerging market economies' financial crises, the 9/11 crisis, and the fear of deflation). Second (and related), we have enjoyed strong commodity prices through this period, and they are closely correlated to export prices. There is some evidence that these improved prices might be expected to continue in the future.

We have strong commodity and export prices



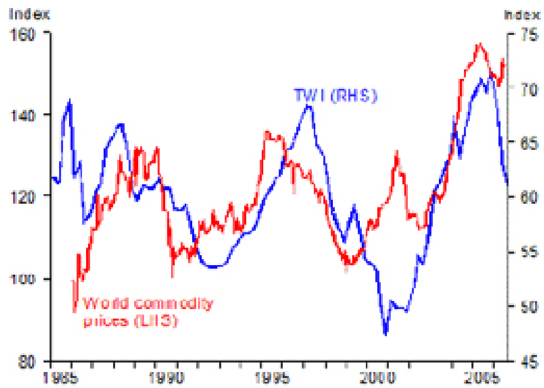
Source: ANZ National Bank, Statistics New Zealand.

As ever, a small open primary-producing country like ours can be subject to considerable volatility, much of it beyond our control in the short-term. We know that climatic factors, especially drought, can be big enough to make a difference to the timing and magnitude of exports. However, tracking these through changes in milk production, dairy product storage, slaughter numbers, onshore and offshore inventory, can be surprisingly complex and lead to big statistical discrepancies at times (for example, the surprisingly low growth figures late last year). Looking back, some economic historians now believe that New Zealand's difficult reaction to the East Asian Crisis in the late-1990s was partly due to a drought shock. Now that droughts are also associated with electricity price hikes, the climatic effect on the economy can be magnified further.

Shocks can also be benign. New Zealand has had its share of "good luck" through the early 2000s with the European Foot and Mouth outbreaks impacting on sheep prices, the North American BSE cow infections limiting Japanese consumption of US beef, and recurrent Australian droughts limiting supply from there. What we used to see as New Zealand's tyranny of distance has been helpful in limiting biological incursions and underlying our environmental image.

The other major feature through this period has been some big changes in land use, especially the major expansion of dairying into the South Island, helped by good prices, warmer climates, irrigation technologies, and Fonterra's general confidence about the future. Of course not all of the buoyant international prices have been received by New Zealand farmers, because of the recently strong New Zealand dollar.

With gains in world prices being offset by strong exchange rate

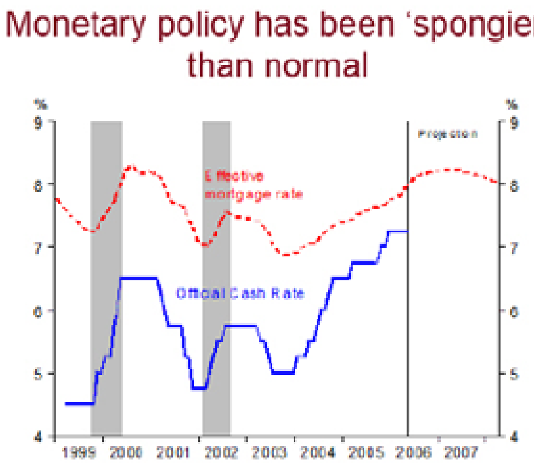


Source: ANZ National Bank, RBNZ.

Farmers have become more sophisticated in dealing with volatility. They have learned from the foreign exchange exposures of the 1980s and the debt build-ups in some sectors, to integrate financial advice with agronomic decisions. There have been very big exchange rate cycles in recent years, although to some extent these have tracked our terms of trade in the way economic theory predicts they might, and hence helped cushion the economy from big moves in prices. When our overseas prices are high, a strong dollar tells New Zealanders they are richer, and vice-versa. That is not to say that there is not scope by financial institutions and primary processors to develop new instruments to lessen exchange and interest rate risk, to offset capital risk, and to better incentivise farmers with longer term contracts.

Despite this, we do still have a problem of imbalance ahead of us. As New Zealanders have enjoyed this strong period of growth, they have invested heavily in housing, with consequent increases in household prices. A central bank might prefer to "look through" a period of asset price inflation, rather than trying to address it with tighter monetary policy. That is an issue that is still argued about overseas. We did not feel we had the option of sitting back and waiting for the market to "burst", for two reasons - the housing market has been an indicator of very strong activity through the broader economy; in addition, strong house prices have made New Zealanders feel richer and in turn spend very freely, bidding up prices elsewhere.

As we approached this problem, the Reserve Bank encountered an issue that has been around in lesser form before: we increased the Official Cash Rate at a time when G-3 economies, worried by deflation, were running the loosest monetary policies for 30 years. We could influence short-term rates, but took a longer time to see this coming through on effective mortgage rates, because banks were able to restructure mortgages to fixed term and fund at lower international rates.



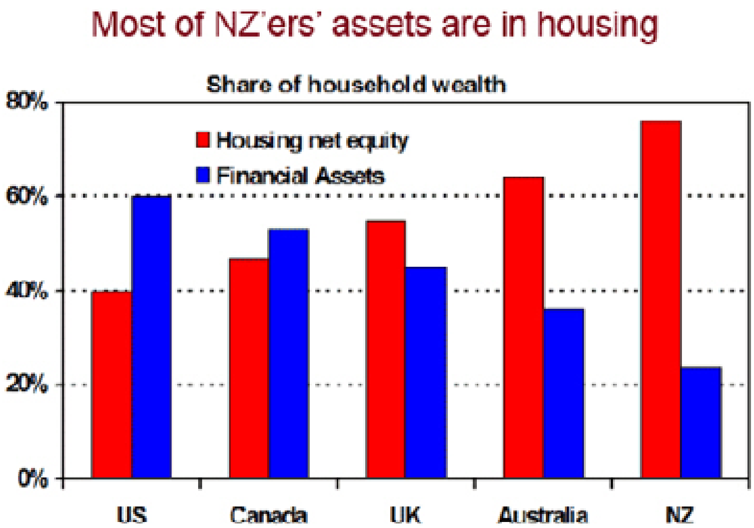
Source: RBNZ.

This is not to say that monetary policy was impotent through this period; merely that its effects were slower to eventuate. This made it necessary to pre-signal to householders the pipeline impact. It also makes it harder to judge the timing of monetary policy moves around the business cycle with as much precision as we might like. Interestingly this is a problem that other central banks overseas are now also starting to worry about, though their economies are at an earlier stage in the cycle.

The collateral problem this caused was that as we tightened monetary policy, the New Zealand dollar looked increasingly attractive to offshore investors. This was by no means the only driver of $NZ strength (which in the medium term has been more affected by our terms of trade), but for a while it was a significant one. In particular, during 2005 we saw a strong demand offshore for Uridashi and Eurokiwi bonds denominated in $NZ. Of course we might like to blame offshore investors for the resulting pressure on our trade weighted index, but the other side of the account has been New Zealanders' continuing demand for mortgage finance, and the banks' willingness to supply it.

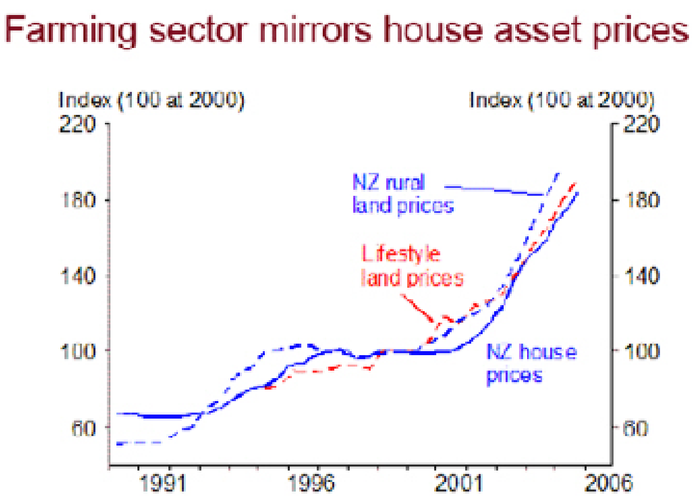
The impact of this boom on the household sector has been quite marked: as house values have risen, both households and banks have been keen to increase mortgages and leverage up financing. Householders feel richer (as indeed they may be if house prices stay high) and borrow and spend more off the back of that. And rather than diversify their wealth, they have been more inclined to invest further in housing - directly and indirectly.

Household balance sheets have more assets and more debt, so are much bigger in gross terms. They, however, look much less balanced because such a dominant proportion of their assets are held in housing, with a relatively small proportion of wealth held in equities, bonds and other instruments. This is in contrast to other OECD countries.



Source: OECD, RBNZ.

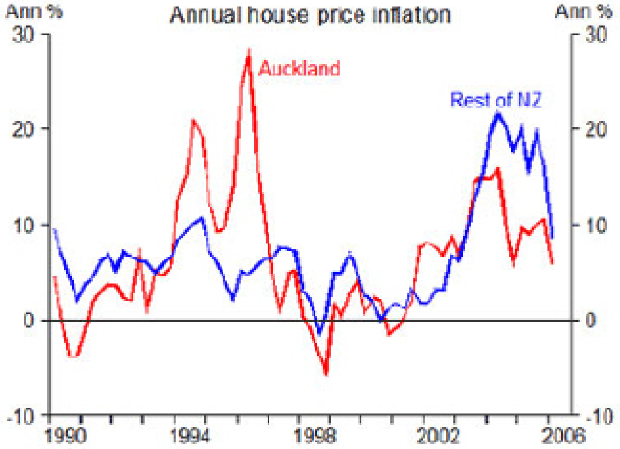
This is worth focusing on because the same phenomenon is happening to a large extent in the farming sector. Farmers are unusual because statistically they constitute both households that consume and businesses that produce, thus complicating analysis of balance sheets. But when we look at farms as a business we see some trends that look rather like urban households.



Source: Quotable Value Ltd.

Farmers with strong pay cheques over the last five years have been responsible for some of the pressure on housing and on second homes around the countryside (one reason why this housing boom has been much more regionally diverse than the Auckland-dominated house boom of the mid-1990s).

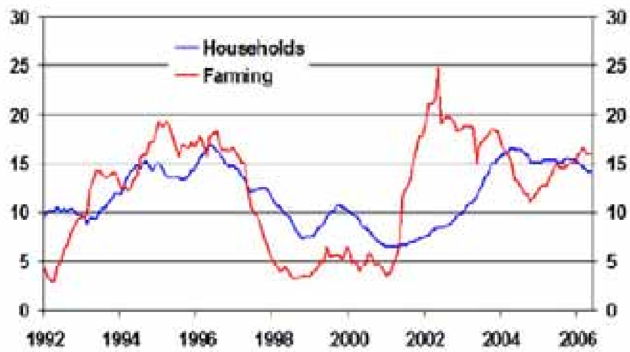
Strong rural incomes have underpinned housing market



Source: REINZ.

In addition, agricultural land prices have been bid up significantly, a consequence partly of good commodity prices, partly of farm aggregation, partly due to productivity increases, partly due to Fonterra-supply effects, and partly due to the availability of cheap credit. We have seen a strong period of lending to the farming sector. These are largely rational reasons why farmers might be willing to pay higher prices.

Strong credit growth in farming sector

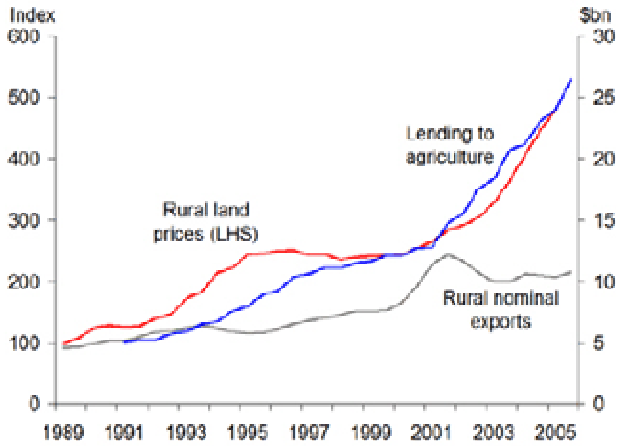


Source: RBNZ.

However these values are changing the nature of some farm balance sheets: it has become increasingly hard to try to rationalise prices paid for land using estimates of the future flow of income from the land. Such estimates have always revealed a "rural lifestyle premium" for agricultural land, but this premium is now starting to look rather unrealistic. Higher prices for land have looked reasonable when compared to product prices in past years. Returns to farming were very good until 2003, as the unusual mix of high international commodity prices and a low New Zealand dollar combined to make farming more profitable than any time in the past 30 years.

But do high land prices today reflect the future income stream available from the land, or past effects? Farmers are effectively saying they expect good export prices to continue into the future. But for land prices to continue to grow at these rates requires improbably high increases in export prices and productivity. There appears to be a gap opening up between land values and expectations of returns. Future investment decisions should not be based on the expectation of ongoing double-digit growth in land values.

Rural land prices need to reflect future earnings potential



Source: Quotable Value Ltd, Statistics New Zealand, RBNZ.

An important part of farming is the management of risks. At any time the sector needs to be able to withstand a combination of risks from poor weather, falling land prices, unhedged exchange rate pressures, trade restrictions, animal disease, and falling commodity prices, especially in an environment of rising operating costs.

Agricultural lending, at about $28bn, now represents around a third of registered bank lending to the corporate sector in New Zealand.

I should emphasise that when we examine rural sector balance sheets and bank lending exposures we do not see generic signs for financial sector concern. The Reserve Bank's *Financial Stability Report* suggests banks do not look over-committed in the agricultural sector and farmers are unlikely to renege on debt. What concerns us more is that we could be heading to a period of lower economic returns from over-investment in land.

At the moment the New Zealand economy is moving into a rebalancing period. A strong domestic sector is weakening, while the export sector is gradually strengthening, helped along by a softer New Zealand dollar. With our current account deficit over 9 per cent, this is a rebalancing that has to take place. From an overall economic viewpoint, we are pleased to see it underway.

The big question for us is: will this rebalancing take place during a period of continuing strong world growth and good commodity prices? This is of course a complex question, but there is some reason to be optimistic - there is evidence that we may be enjoying not just one-off factors, but a better enduring trend in prices for our production than has been the case for some time. It is not quite the story of the 1960s again, but medium-term prospects do look better than the turbulent 1980s and 1990s.