# Alan Bollard: Keeping inflation anchored during economic recovery

Speech by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand and Mark Blackmore, Special Adviser, Economics Department, to the Taranaki Chamber of Commerce, New Plymouth, 19 August 2010.

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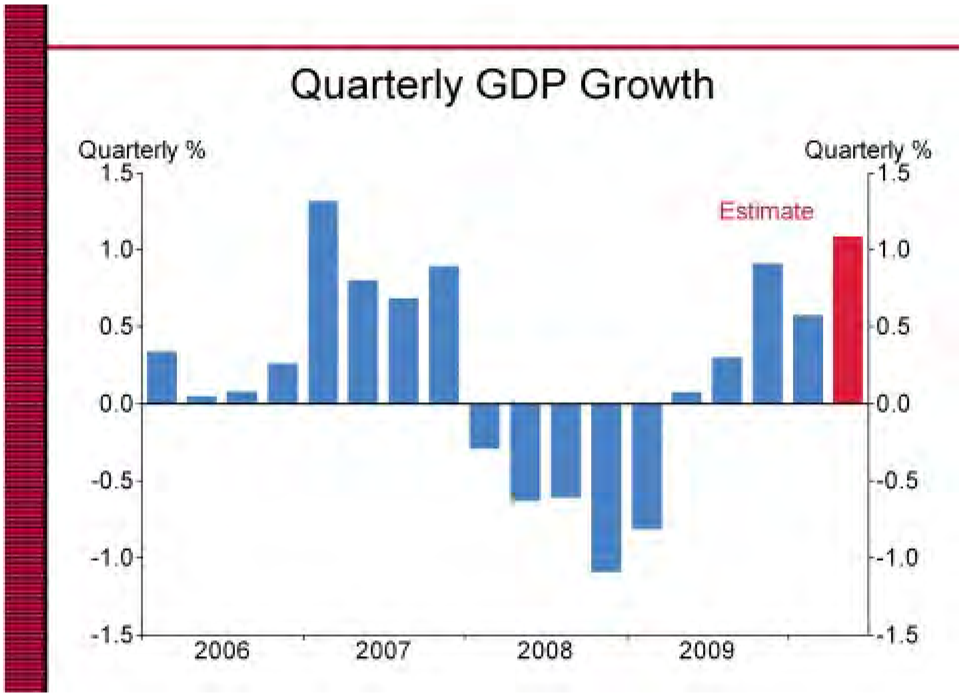
The main theme of my commentary today is inflation during the recovery, what we expect to happen with the forthcoming increase in GST and what it means for monetary policy.

The New Zealand economy is into its second year of recovery with much of the ground lost during the recession already made up.

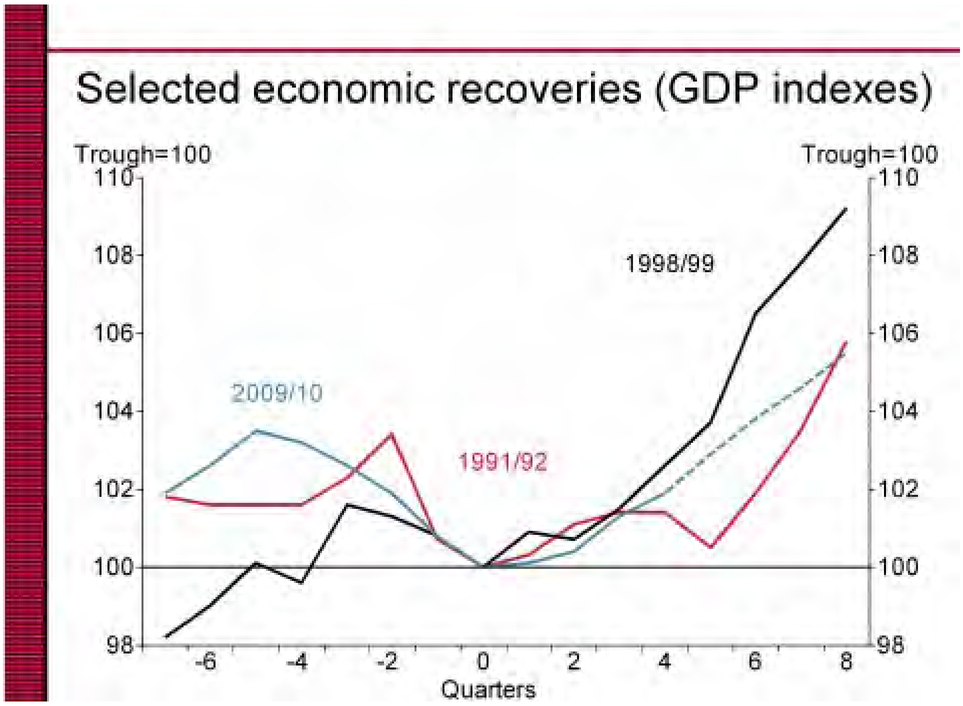
The economy has been growing since the June quarter of 2009 and we are now in this September quarter in the sixth quarter of growth. Initially growth was very muted but it picked up a little momentum towards the end of last year.



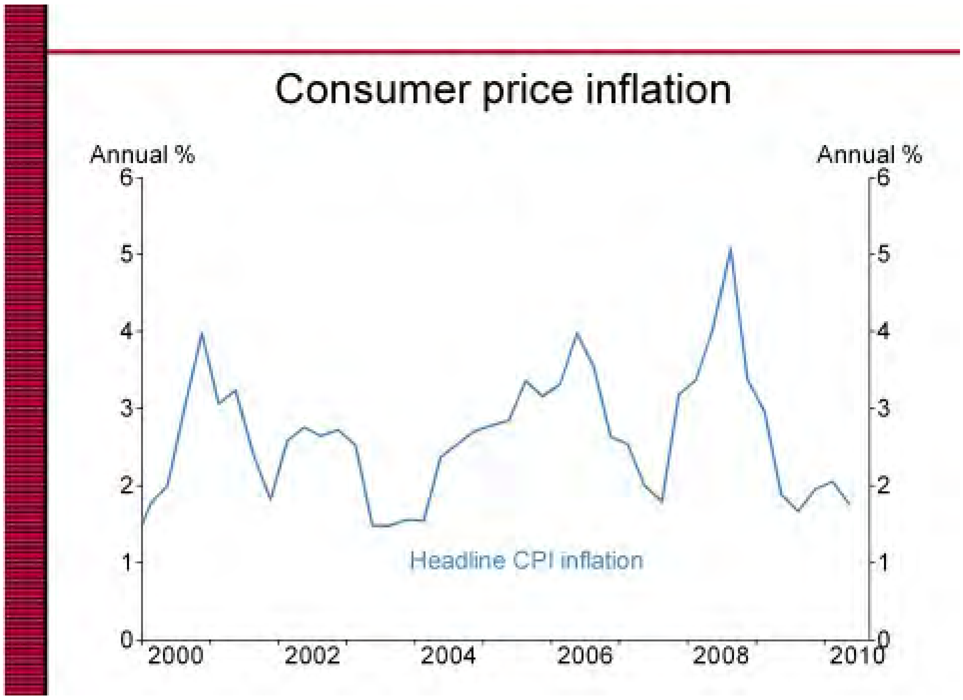

Compared with some past recoveries this is certainly not a fast or robust one. So far, it is comparable with the initial slow rebound from the 1991 recession. It lags behind the 1998/99 recovery from the East Asian crisis, which is probably freshest in most peoples' minds.

We should not really be surprised by the gradual nature of the recovery. The global shock that hit us was, something like a once-in-a-generation event. We also still have to work off some of the excesses of the past expansion, such as high levels of private indebtedness along with reducing the fiscal deficit. These will remain a drag on growth for some time yet, as they are in a number of OECD countries. As a result the recovery still has some fragility about it.

We do, however, expect GDP growth to continue, with the emphasis on export growth as household and business spending remain subdued. This outlook and the associated policy implications will be reviewed over coming weeks as we prepare the September *Monetary Policy Statement.*

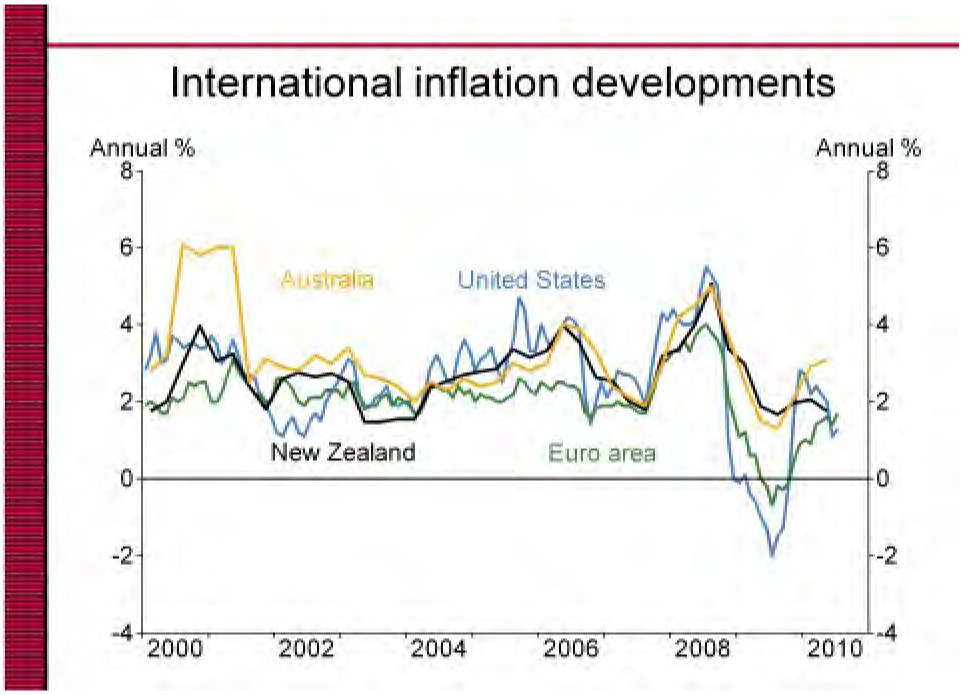



What does this imply for inflation? Inflation has been well contained recently, with consumer prices increasing 1.8 percent in the 12 months to the June quarter this year. This marks five consecutive quarters where annual consumer price inflation has been at or close to the mid-point of the Reserve Bank's 1 to 3 percent inflation target.




It is worth noting that this contained inflation picture comes after a period of very strong growth in the prices of domestic assets and international commodities. Both played a major part in the strong inflation pressures New Zealand experienced in the mid-2000s.

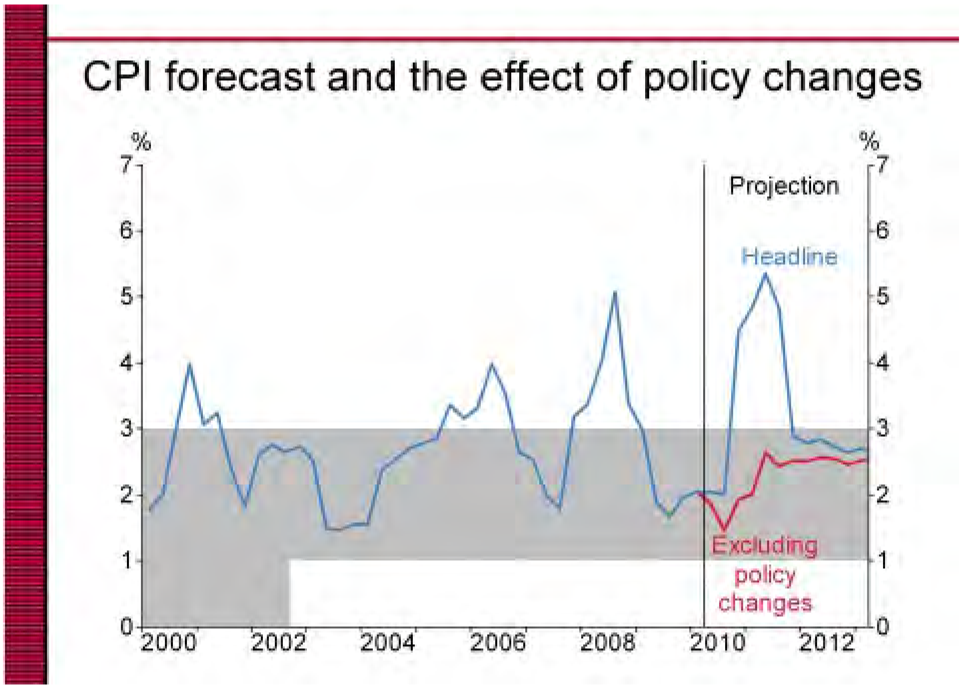
How does this inflation performance compare with other countries?




Globally, consumer price inflation has reduced as a result of the financial crisis. It actually went negative in the US and Euro area for several quarters on the back of lower energy and food prices, but it has since rebounded a little. Measures of so-called "core" inflation in these countries have been trending down since the start of the crisis.

The inflation record in Australia has been similar to New Zealand, except over the past few years as their economy avoided recession and some price pressures continued.

In New Zealand there have already been several government policy developments that have affected prices: the amended Emissions Trading Scheme coming into effect on 1 July, changes to tobacco and excise taxes and ACC charges all have had significant effects on inflation. Despite this, consumer price inflation is likely to be close to 2 percent again in the September 2010 quarter.



However, the most significant event is the increase in the rate of GST on 1 October. This will push headline inflation substantially higher. This mainly involves direct effects of GST on goods and services purchased.

The figure shows the forecasts we published in the June *Monetary Policy Statement*, implying some price pressure this quarter and a 2 percent price shock next quarter. Since then our expectation of the peak in inflation has eased back to around 5 percent or just below.

The figure shows that the spike in inflation is expected to be short-lived. The inflationary effects should be largely out of the system by later next year.

Our industry intelligence to date suggests that the GST increase is not being treated as a big disruptive event by the retail industry. Pre-stocking does not appear major, nor does pre-purchasing, and a last quarter sales fall-off is not expected. The spending effects of the GST increase are counter-balanced by the income tax reduction.

As the economy grows, employment levels are expected to increase, and plant and equipment will be worked harder. As this occurs underlying inflationary pressures are likely to gradually increase, but consumer price inflation is forecast to remain comfortably inside the target band in the second half of our forecast horizon.

Higher headline inflation would obviously pose a challenge for monetary policy. There have, of course, been periods in the past when inflation moved temporarily outside the Bank's target band. The Policy Targets Agreement with the Government deliberately gives the Bank the ability to "look through" temporary inflation spikes.

The Agreement defines the Bank's price stability target in terms of the Consumers Price Index. However, it also instructs us to focus on the medium-term trend in inflation, and lists changes in indirect taxes and significant government policy that directly affect prices as specific reasons why inflation might vary around its medium-term trend.

As such, monetary policy will not attempt to offset the immediate direct inflation impact of the coming policy changes.

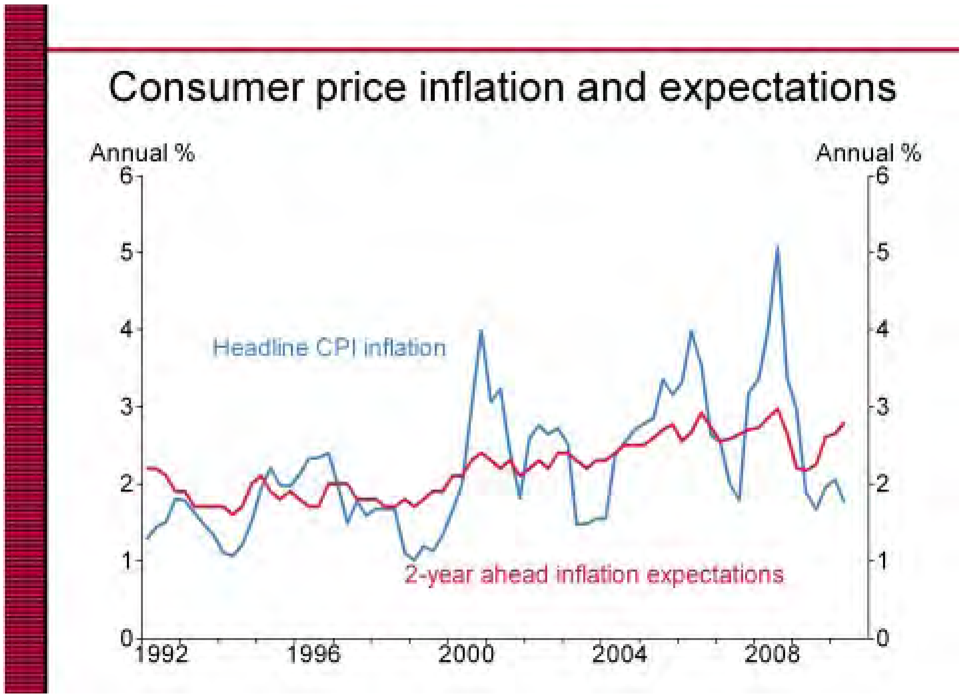
Given the staggered nature of the indirect tax increases and the progressive introduction of various sectors to the Emissions Trading Scheme, there is an additional risk that the coming spike in inflation causes consumers and businesses to reassess their expectation of medium-term inflation.

The degree to which monetary policy can "look through" temporary inflation spikes depends crucially on the extent to which New Zealander's inflation expectations are impacted by such spikes. Of late, inflation expectations have risen from the lows seen at the trough of the recession but they remain contained. Two-year-ahead inflation expectations initially lifted late last year, when there was some talk of the housing market gaining significant momentum again and the economy had clearly moved out of recession.

Subsequent to that we saw excise taxes rise, the ETS-related charges become more definite and the announced rise in GST. All of these are likely to have played some part in inflation expectations staying up, even as the housing market has eased off and the pace of the recovery has remained moderate.

However, the Reserve Bank does not expect the forthcoming price spike to have a lasting impact on inflation expectations. (In support of this, the just-released AON survey shows that longer-term inflation expectations have not moved as a result of the impending GST increase.)

The GST increase in 1989 did not materially affect inflation expectations, and again we expect this to be the case in 2010. As in 1989, personal income taxes will be reduced on 1 October, offsetting the impact on disposable incomes coming from the GST increase.




Other temporary spikes in inflation have also not generally fed into inflation expectations and the Reserve Bank has been able to "look through" the immediate impacts of the price change. This is one of the big pay-offs of keeping inflation well anchored.

Nonetheless, the price and wage setting behaviour of firms and households will be monitored for evidence of indirect and second-round effects on inflation. For now, it is assumed that the coming policy changes will have only limited impact on perceptions of future inflation.

The key to ensuring no significant effect on inflation expectations is for businesses, labour groups and households not to use the GST increase as a veil to increase margins and wages. Doing so would simply spread inflation and harm the recovery.

The extent of indexation in the economy is much less than it was decades ago, but there are still some wage and price adjustments that are unavoidably linked to the consumers price index.

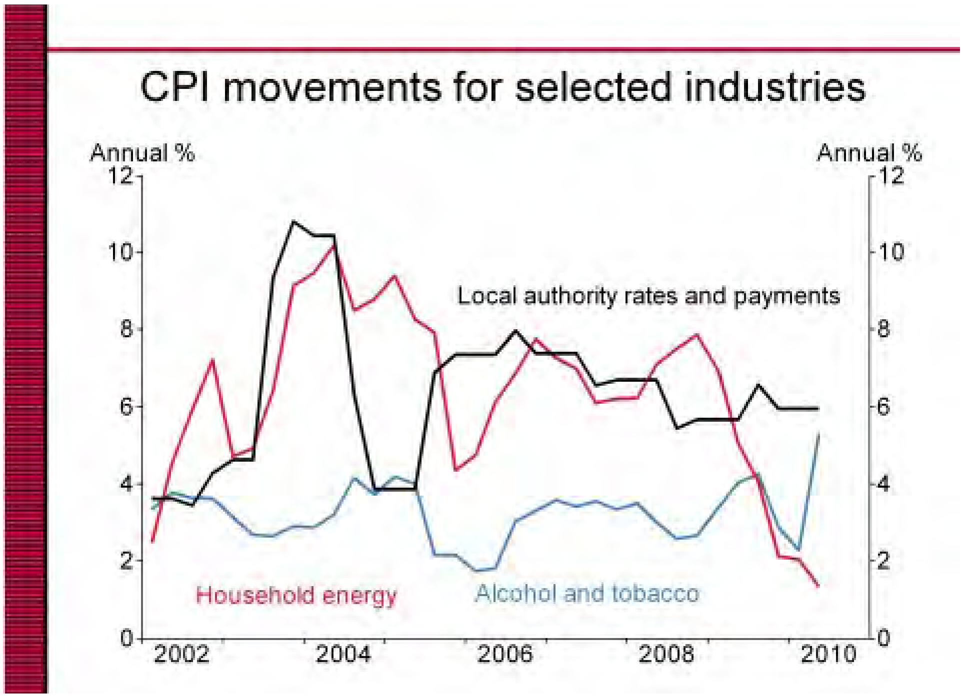
The 1 October income tax reductions mean most people are already compensated for the effects of the GST increase. Given this, there is less argument for one-off CPI-indexed wage increases.

A particular message of restraint is for those parts of the economy, both public and private, that have a record of increasing prices by more than the rate of economy-wide inflation.

We expect to see relative prices change in a well functioning economy. In a competitive market they represent an important signal for resources to move around the economy in search of more profitable opportunities. A good example is the agricultural transformation that has occurred with the rise in dairy prices. There may also be public policy reasons why some prices move more than others.

But there are also examples of persistent price increases in sectors that have not suffered persistent cost increases, and these have an inflationary effect. The diagram shows the impact of excise tax increases on alcohol and tobacco industries, and that the energy and local authority sectors have recorded persistently high price pressures.

Given the fragility of the recovery it is important that firms base their pricing decisions on low underlying inflation, and not the forthcoming temporary spike.




Monetary policy would need to respond if inflation expectations and prices were ratcheted up significantly. The result would be higher interest rates and a dampening of the economic recovery. We are hopeful this will not need to be the case, so that monetary policy can play as full a part as possible in supporting economic growth.