Mr. Brash looks at economic developments and their bearing on inflationary trends Speaking notes of Mr. Donald Brash, Governor of the Reserve Bank of New Zealand, on the release of the September, 1997 Economic Projections in Wellington on 17/9/97.

Introduction

Good morning, and welcome to this briefing on the Reserve Bank's September 1997 Economic Projections.

You will recall that, in contrast to our June and December Monetary Policy Statements, which the Bank is obliged to produce by statute, the Economic Projections which we release each March and September are more in the nature of 'self-initiated' documents. Their primary purpose is to assist us in assessing economic developments that have a bearing on inflation trends, and thereby to assist us in forming judgements on how monetary policy should evolve. In publishing our Projections, we take the opportunity to inform financial markets and the public generally on what is driving our day-to-day policy decisions. Typically, you can expect to see in our Economic Projections more discussion of matters such as investment behaviour, labour market trends, the balance of payments and so on than is to be found in our Monetary Policy Statements, which concentrate more on assessments of past and future financial market conditions, and the stance of monetary policy.

However, both documents require us to produce a comprehensive view of the future trends in the New Zealand economy, and to test our previously articulated views against the stream of emerging data and opinion. A key ingredient in that process is our new forecasting and policy system (FPS) -- the system of models we now utilise in developing our Projections.

One important change which that new system of models has made possible was introduced with our June Monetary Policy Statement. Whereas we had previously projected inflation on the basis of an assumed track for interest rates and the exchange rate, in June we shifted to a structure that constrains our Projections of inflation to converge on the mid-part of the 0 to 3 percent inflation target, while allowing the track of monetary conditions to vary as necessary to produce that outcome. You can see that process at work again in these Projections .

One point made in relation to FPS when it was first introduced bears repeating. While it is an important tool which helps shape our view of the economy and its likely future path, it is not a 'black box'. FPS provides a coherent framework for thinking about the economy, but considerable judgement is still required to arrive at a final projection. There are clearly a number of different paths through which the economy can evolve to essentially the same point. What is portrayed in this document is just one of those paths, but one that we feel is both realistic and sound as a base for our policy judgements.

The real economy

Shortly after our June Monetary Policy Statement was published, the release of March quarter GDP data seemed to suggest that the economy was significantly weaker than we had allowed for. Our subsequent analysis indicated that there were particular factors (notably that Easter, unusually, fell into the March quarter) which explained much of the small decline in GDP in that quarter.

Since then, the emerging data have suggested that the economy is a little weaker than we had portrayed in June, but that it is also resuming a robust growth path. Whereas we were projecting an annualised growth rate through the first half of calendar 1997 of a little over 1 percent, the estimate incorporated in these Projections is closer to 0.5 percent. Having said that, data released since we completed the Projections are, if anything, suggestive of stronger rather than weaker outcomes for June quarter GDP. In any event, we remain of the view expressed in June that activity will pick up in the second half of the year. Over the year to March 1998, we expect the economy to expand by around 2.5 percent, accelerating further to 4.6 percent growth in the year to March 1999.

The factors driving that expansion include a robust global economy, gradually increasing household expenditures, improved productivity, stronger exports (partly the result of a lower exchange rate), business investment and an expansionary fiscal policy -- both from increased government spending under the Coalition Agreement and from the tax cuts scheduled for July 1998. Easier monetary conditions since earlier this year are also supportive of stronger growth.

It seems clear that, in the middle of this decade, the New Zealand economy became somewhat over-stretched in terms of its ability to support the pace of spending. It seems equally clear that the economy has entered a period in which there is some spare capacity. Given the current and imminent expansionary forces that I have described, the spare-capacity phase should be short-lived, but long enough to take the pressure off inflation, and long enough to make it unlikely that we will experience the kind of destructive crunch that has so often brought past cycles to a shuddering halt. In this sense, we are describing a growth profile that reflects the steadying influence of maintaining low inflation, which in turn should contribute to New Zealand's future growth potential.

We expect continued job creation throughout the period to March 2000, continued growth in real disposable household income (averaging over 3 percent per annum through the projection period), continuing modest fiscal surpluses, further declines in the government's debt-to-GDP ratio, and an improvement in the current account deficit from nearly 6 percent of GDP to around 4 percent of GDP.

Inflation

As I mentioned earlier, our new Projections framework takes as given that inflation should converge on the mid-part of our target range, and derives the monetary conditions that are needed to achieve that outcome. In that sense there is no particular news in the fact that we expect underlying inflation to be close to the middle of the target over the projection period. But there are some aspects of the inflation track that require comment.

In particular, we now expect inflation outcomes over the next two quarters to be rather higher than was the case in June. There are two principal sources of that upward revision.

First, the last few months have seen a 6 or 7 percent depreciation of the trade-weighted exchange rate. The increased inflation now expected over the next two quarters is, in part, a direct consequence of that depreciation.

Secondly, domestic inflation continues to be strongly influenced by the policy decisions of the Government. We now estimate that, over the next two quarters, policy-related increases in Housing New Zealand rentals and tertiary education fees could well exceed the

materiality threshold which is applied in determining our measure of underlying inflation. In that event, underlying inflation would be slightly lower than the estimates given in these Projections.

Policy Implications

We now view an MCI level of 725 as being appropriate for the next quarter. This is 100 basis points lower than the desired MCI level which has applied for the last quarter, but roughly equivalent to actual monetary conditions over recent weeks. You will recall that a 100 point reduction in the MCI is equivalent to a 1 percentage point decline in 90 day bill rates, a 2 percent decline in the TWI, or some equivalent combination. You may also recall that the average MCI for the December 1996 quarter was 1000. The extent of easing over the past nine months has clearly been significant, although certainly off a high base.

Our Projections point to further, but quite small, easings in the first two quarters of 1998 before emerging inflationary pressures lead us to expect monetary conditions to enter another tightening phase. However, as we make clear in our policy assessment section, whether those further easings eventuate in 1998 is very much dependent on how the economy develops over the next few months. Financial market participants eager to bring forward the small, and conditional, easings shown in these Projections clearly do so at their own risk! On the face of it, with inflation over the next two years, and especially over the next two quarters, being a little higher than we thought likely back in June, easing now by more than we foreshadowed in June may seem surprising. The explanation is straightforward, and relates to the lags inherent in the operation of monetary policy. While inflation is a little higher in the short term than we had previously expected, it is still well within our target range, and has been boosted by factors which should be essentially transitory, such as the impact of moving Housing NZ rentals to market. Of more relevance to the outlook in 18 months to two years' time is the margin of spare capacity in the economy. That now looks somewhat larger than it did previously, and warrants somewhat easier monetary conditions. Although activity will be accelerating through 1998, it is not until 1999 that the inflation pressures associated with strong growth begin to emerge. A gradual tightening of monetary conditions from mid-1998 fits with that profile.

There are, of course, alternative paths for monetary policy that could deliver inflation within our target range. As was discussed in June, one alternative path would involve more aggressive easing now, followed by earlier and more aggressive tightening next year. Another path would involve holding conditions relatively flat at about current levels until the latter part of 1998 before beginning a somewhat gentler tightening beyond that date. Inevitably, there is rather more art than science in selecting the best of these alternatives. What we have chosen reflects the risks that we see around us at present, and also reflects the benefits we see in providing a relatively smooth path for monetary conditions over time.

The mix of monetary conditions

On numerous occasions over the past year or two, I have indicated that the particular mix of monetary conditions was unhelpful -- that the exchange rate was too high, putting excessive pressure on exporters, and that interest rates remained too low to discourage borrowing for housing purposes, or to encourage increased domestic savings.

The past quarter has seen a substantial, and welcome, shift in the mix of monetary conditions in the direction we believed appropriate. The fall in the exchange rate will boost the incomes of exporters and those competing with imports, and will ultimately increase export volumes. The projected improvement in the current account balance reflects that. The increase in

interest rates is also helpful, given the continuing pressures we have seen in the domestic or non-tradeables sector of the economy, and especially in real estate markets. There is no benefit to New Zealand in seeing real estate prices increase to a point where they become vulnerable to a sudden, and damaging, correction. (Anyone who has been observing events in South-East Asia over the past couple of months will be conscious of the enormous damage that can be inflicted in those circumstances. Our own experience post-1987 is also instructive in that regard.)

The shift in the mix of conditions, while substantial, has occurred in a manner which is fully consistent with our inflation target, and fully consistent with our use of an MCI in assessing the overall stance of monetary policy. It is certainly the case that the sharp decline of the exchange rate will boost inflation to some degree in the short term. That is already apparent in our Projections. But even with that increase, projected inflation remains well within our target range. And the increase in interest rates that has accompanied the exchange rate fall will work in the opposite direction, dampening inflation in the longer-term.

The MCI

At the time when the exchange rate was declining, and interest rates were rising, we heard a good deal of criticism of our MCI. It was, it was claimed, too rigid; it was forcing up interest rates at a time when the economy was already in recession; it was based on a relationship between interest rates and the exchange rate which was no longer valid; and so on.

As I made clear in my speech to the Counties Kiwifruit Growers Association on 22 August, I regard those criticisms as ill-founded. I think the MCI structure has performed admirably over the past three months. In making that assessment, I think it is important to reflect on just how volatile international exchange rates have been over that period. Any of the alternative monetary policy arrangements we could have adopted in place of the MCI would also have been subject to a good deal of stress. I certainly see no reason to change the MCI approach at this point.

Likewise, the description I offered in June of how the Bank might react to deviations in actual market conditions from the central or ‘desired’ MCI track appears to us to have weathered the tests of the past quarter rather well. I see no reason to modify that description now, and our response to evolving market conditions over the next three months will be consistent with my comments of June.