Mr. Brash speaks on monetary policy in New Zealand Address by the Governor of the Reserve Bank of New Zealand, Dr. Donald T. Brash, before the Auckland Chamber of Commerce, in Auckland, on 20/4/98.

I very much appreciate this opportunity to address such an important Auckland audience at this time. We all know that, on 18 March, the Reserve Bank announced a further easing of monetary policy, an easing which was rather larger than most people had been expecting. Since then, the exchange rate has fallen and interest rates have risen (especially at the short end of the yield curve).

These developments have led to a great deal of puzzlement and some anger. What kind of easing is it which leads to an increase in interest rates? Hasn't Don Brash become just like Rob Muldoon, interfering in the market and manipulating first this lever and then that - perhaps initially focused on keeping inflation low but now, worried by the balance of payments deficit, pushing down the exchange rate to help reduce that deficit and pushing up interest rates to punish Auckland house buyers? Why do we need the Reserve Bank interfering in financial markets at all, now that we have a largely deregulated economy? Surely the easing was totally 'botched'?

This morning I want to answer those charges. (I will not be making any comments on the current level of the MCI, or about what the Bank might or might not do about it.)

Central banks are an 'intervention', but the RBNZ is not 'Muldoonist'

Let me begin by stating at the outset that central banks are an intervention in the economy. The Reserve Bank of New Zealand probably has less direct control over financial market prices than any other central bank in the world - we haven't intervened in the foreign exchange market for 13 years, for example, and don't fix any single interest rate - but I do not deny for a moment that we intervene to influence overall monetary conditions.

I do not want to be side-tracked into a long debate about the virtues of having a central bank, beyond simply observing that for all practical purposes we either have our own central bank, as the great majority of countries do, or we abandon our own currency and use the services of some other central bank, such as Hong Kong and Argentina effectively do (they use the services of the US central bank of course). As long as we want to retain our own money, we need to have a monetary policy, and some institutional structure with which to implement that monetary policy.

The key issue is what that institution, typically a central bank, should try to achieve with its powers. I presume that those who accuse us of having become 'Muldoonist' believe that we have given up our single-minded pursuit of price stability and have instead started using monetary policy to achieve other objectives, perhaps trying to help to reduce the balance of payments deficit or trying to deflate property prices. Some people have of course welcomed this 'more pragmatic approach'. I don't think even our worst critics have accused us of manipulating monetary policy for political purposes, which of course was one of the accusations levelled against Rob Muldoon.

So let me say it again: monetary policy has been exclusively focused on delivering low inflation in accordance with the target agreed with Government (initially 0 to 2 per cent, now 0 to 3 per cent) since at least the time I was appointed Governor, now almost 10 years ago. Monetary policy *remains* focused exclusively on that objective. Indeed, any other focus for monetary policy would be inconsistent with the legislation under which the Reserve Bank operates, passed without dissent in 1989.

But it is important to recall that price stability was not chosen as the single objective of monetary policy because Parliament thought that other objectives were unimportant. Rather, by the late eighties it had become increasingly recognised here and abroad that the best contribution

which monetary policy could make to those other objectives - social justice, growth in employment, growth in output - was to deliver predictably stable prices. And indeed, this point is now recognised quite explicitly in the wording of the Policy Targets Agreement between the Treasurer and myself.

Monetary policy aimed at stable prices assists social justice by avoiding the kind of capricious transfers of income and wealth which are the inevitable result of inflation.

Monetary policy aimed at stable prices assists growth in output and jobs by helping the price system, which is at the heart of the market economy, work more effectively.

And monetary policy aimed at stable prices assists the economy by helping to smooth business cycles. Ah, you say, he admits it: the Reserve Bank is using monetary policy to try to smooth the business cycle. No, I am not saying that at all. What I am saying is that when monetary policy is aimed at delivering stable prices it has the *ancillary benefit* that the business cycle may be smoothed to some degree also. Why? Because the situations where inflationary pressures are increasing are by their nature usually situations where demand in the economy is running ahead of the economy's long-term capacity to supply, so that monetary policy aimed at restraining those inflationary pressures inevitably tends to dampen down booms. And conversely, those situations where demand falls short of the economy's long-term capacity to supply are usually situations where inflationary pressures are falling towards zero, so that monetary policy aimed at preventing inflation falling below zero (as required by my agreement with the Treasurer) inevitably tends to work to mitigate those downturns.

In determining the stance of monetary policy, we are inevitably trying to assess what future inflation pressures will be. That means we are always trying to assess how demand pressures will evolve relative to the economy's ability to supply. Are we primarily trying to smooth business cycles? No, we are trying to maintain consistently low inflation within the target we have agreed with Government, but one of the corollaries, one of the ancillary benefits, is that, if we get it right, the business cycle will be somewhat moderated also - less vigorous booms and less recessionary busts. As one of America's leading monetary policy economists, Larry Ball of Johns Hopkins University, has recently argued, even if you were mainly concerned to smooth output and employment cycles, focusing monetary policy on delivering predictably low inflation would be the most sensible way of running monetary policy.

So let's make this abundantly clear. The Reserve Bank has not had some sort of road-to-Damascus experience. We have not decided that inflation matters less and that we have to 'go for growth'. We have not decided to fix the current account. We have not decided to get the farmers back in the black. And we have certainly not, as columnist Chris Trotter put it, anticipated 'the National Government's political needs'. The easing process that is now underway is absolutely intrinsic to, and an inevitable result of, the monetary policy framework that has applied in New Zealand since the passage of the 1989 Reserve Bank Act. More precisely, it is the inevitable result of an inflation target which has an upper and a lower limit. Recent events are therefore just 'business as usual'.

Recent changes in interest rates and the exchange rate

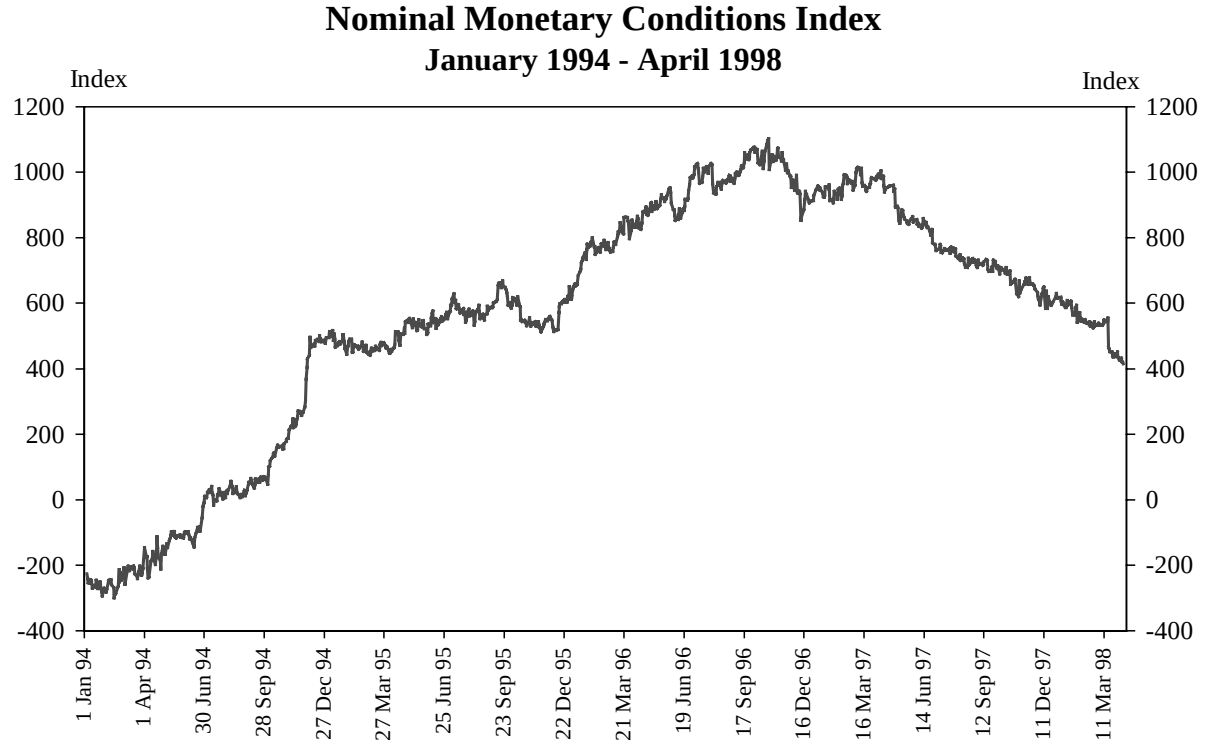
But, you ask, hasn't the Reserve Bank just deliberately knocked down the exchange rate and increased interest rates? Doesn't that suggest that the Bank has taken its eye off the price stability ball, and is now trying to manipulate conditions in order to reduce the balance of payments deficit? That is certainly a widespread perception, but it is totally wrong.

For a very long time, the Bank has argued that, while we can tighten monetary policy or we can ease monetary policy, we can not control the way in which these policy adjustments affect monetary conditions. Put another way, the *mix* of monetary conditions is determined by the

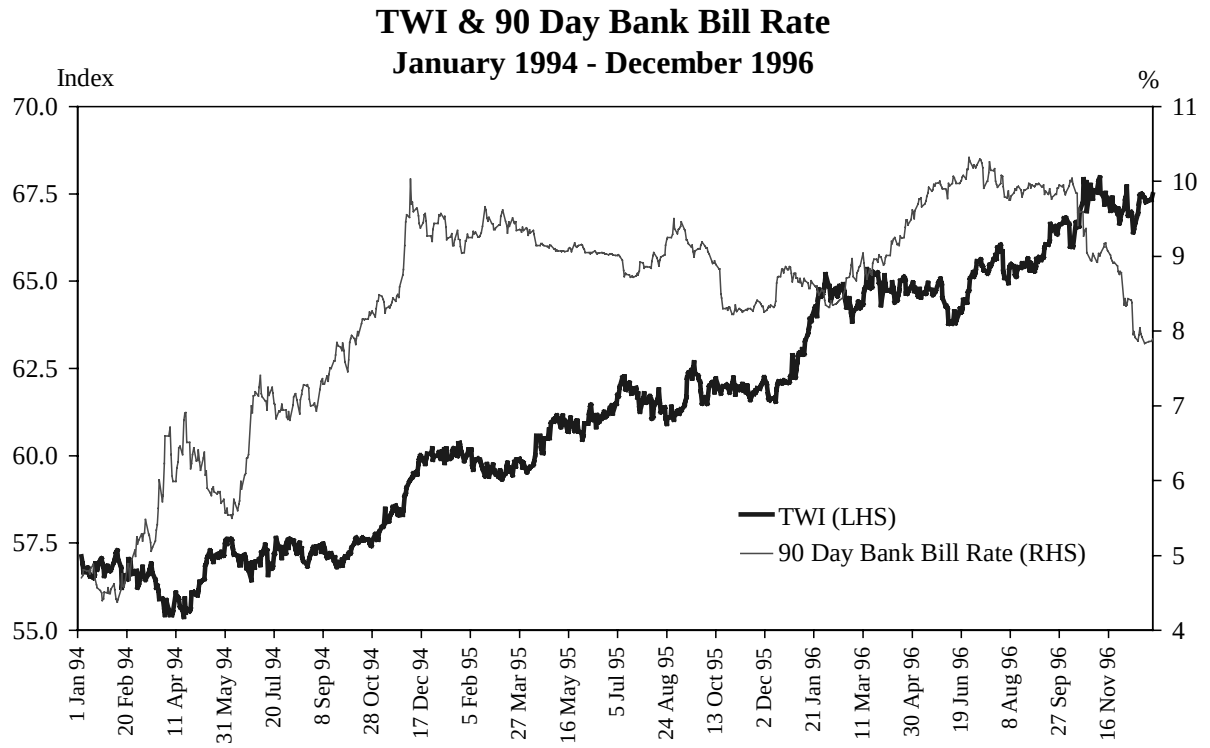
decisions and perceptions of countless thousands of individuals, borrowers and savers, both within New Zealand and overseas.

Let me illustrate that point first by looking not at the events of the last few weeks and months but rather at the period during which monetary policy was being tightened to head off emerging inflationary pressures from early 1994. Graph 1 shows how overall monetary conditions tightened from the beginning of 1994 through to late 1996. In 1994, that tightening took the form of both an increase in interest rates and an increase in the exchange rate, as shown in Graph 2. But through 1995 and 1996, as exporters and those competing with imports know only too well, interest rates fluctuated through quite a narrow band while the exchange rate continued to increase strongly. Indeed, at times the overall firming of conditions took the form of an actual fall in interest rates, more than offset, in terms of the effect on inflationary pressures, by a strong increase in the exchange rate.

GRAPH 1



GRAPH 2



Were overall monetary conditions firming through that period, even though interest rates were stable and sometimes falling? In my view they were, and I suspect that most exporters and those competing with imports are in full agreement.

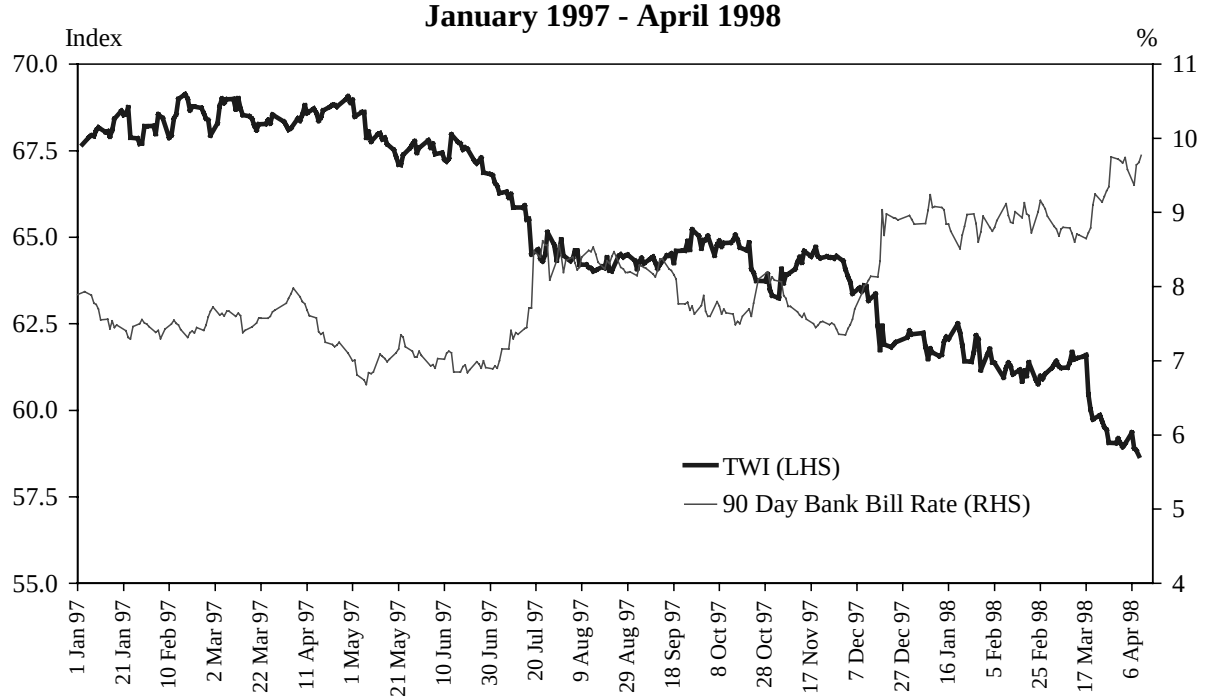
Was the situation ideal? In my view it was not. From our point of view in the central bank, it meant that interest rates stayed too low to restrain the very strong growth in borrowing which occurred through that period, which in turn meant that there was insufficient disinflationary pressure on those domestic sectors of the economy which were the source of so much of the inflation in those years. Conversely, the strong increase in the exchange rate was putting more and more disinflationary pressure on those sectors of the economy in competition with the rest of the world, even though inflation in those sectors was very low. I occasionally expressed my unhappiness with that particular mix of monetary conditions, but I recognised that I was not able to change it.

Over the last year or so of course the process has been substantially reversed. The Bank has been progressively willing to ease overall monetary conditions, and the extent of this easing since the end of 1996 is also shown in Graph 1. But as can be seen in Graph 3, all of the easing, indeed *more than all of the easing*, has taken the form of a fall in the exchange rate, offset in part by some increase in interest rates.

Is this new mix of monetary conditions surprising? Not really, given the widespread perception that New Zealand's balance of payments deficit has reached a high level and given the still-strong demand by New Zealanders to borrow. In other words, our strong demand to borrow and our reluctance to save require us to attract the savings of foreigners. Since those foreign savers have seen an increasing risk that the New Zealand dollar might depreciate, we have had to pay increasing interest rates to offset that perceived risk of currency depreciation.

GRAPH 3

TWI & 90 Day Bank Bill Rate
January 1997 - April 1998



Is the new mix of monetary conditions in some sense undesirable? I am sure it must seem so to many indebted companies and households. On the other hand, I am equally confident that there are a great number of people in the export sector, and in companies competing with imports, who are absolutely delighted by the change in the mix of monetary conditions. So also are those people who derive income from their savings. Predictably, most of them are not issuing press statements expressing their delight, so the overall impression created is that the whole country is miserable about the change.

In my own view, the change in the mix of monetary conditions which we have seen over the last year or so has been a positive development for the economy's medium-term development. It should certainly assist in reducing the currently large balance of payments deficit. Having said that, however, the balance of payments is not an objective of monetary policy - and that's just as well because, as I have noted already, monetary policy has no ability to influence the mix of monetary conditions.

But didn't the Reserve Bank deliberately change the mix, by projecting a weaker exchange rate and higher interest rates in its quarterly inflation projections? Certainly, we did project an easing in overall monetary conditions over the next year or so and, because we have to make *some* assumption about how that easing will be reflected in interest rates and the exchange rate in order to complete our inflation projection, we did indicate that we expected that easing to take the form of a somewhat reduced exchange rate and broadly unchanged interest rates (at least through 1998). But we have routinely disclosed the interest and exchange rate assumptions underlying our inflation projections, and financial markets have understood that these are not assumptions which we necessarily expect to see realised, let alone assumptions which we can in some way enforce on financial markets. In December 1997, for example, we projected that the exchange rate would remain broadly unchanged at 64.2 on the Trade-Weighted Index and the 90 day interest rate would stay at around 7.6 per cent through the first half of 1998. Well before our March projections were published, the exchange rate had fallen well below 64.2 and interest rates had risen above 7.6 per cent. Neither in December 1997 nor in March 1998 were our assumptions about the path of interest and exchange rates intended to *direct* financial markets to particular outcomes.

But hasn't the Reserve Bank's easing been 'botched' in some way? Has there really been an easing at all? On those questions I have not the slightest doubt.

One can debate whether the Bank's Monetary Conditions Index is correctly calibrated, whether a 2 per cent fall in the exchange rate is equivalent to a 100 basis point movement in 90 day interest rates. One can debate whether the Bank's Trade-Weighted Index correctly measures movements in the New Zealand dollar. One can debate whether the 90-day interest rate correctly measures movements in New Zealand interest rates. And I am familiar with all of that debate. (We dealt with several of these issues in the March 1998 *Economic Projections*, and in my speaking notes for journalists in releasing that document.) But if we accept, as I believe we must, that in a small, open economy monetary policy works to affect the real economy and, in that way, inflation through *both* interest rates and the exchange rate, then I don't have the slightest doubt that overall monetary conditions have eased in New Zealand in recent months, and indeed have eased quite considerably. That easing has taken the form of a sharp fall in the exchange rate which has been partly offset by an increase in short-term interest rates (the increase in longer-term interest rates has been much more moderate).

I have often conceded that the MCI is not a perfect measure of monetary conditions. We will continue to seek ways to improve it. But as a rule-of-thumb to guide financial markets between quarterly projections it has proven enormously useful. It has assisted us through a very major rebalancing of monetary conditions at a time of great turbulence in financial markets internationally, with an absolute minimum of drama. Yes, interest rates have gone up, but given our balance of payments deficit - or in other words, our huge appetite for borrowing and our national aversion to saving - that should not be a matter for surprise or regret. If as a nation we become less enthusiastic about borrowing or more enthusiastic about saving, we can expect interest rates to decline to the levels which would seem to be justified by our low inflation.

In conclusion, I think it is important that we all look at recent events objectively. Right now, the New Zealand economy is having to adapt to a complex set of circumstances, including an increase in government expenditure, a reduction in taxation, a changing housing market, and, coming rapidly over the horizon, the negative implications of the Asian financial crisis. Yet what we see is adjustment to these new circumstances, taking place within existing structures, without great drama. Monetary policy, with its single focus on price stability and its total transparency, has reacted as it must, smoothly and objectively. The markets too are dealing with changed circumstances and creating a context within which New Zealand can be more internationally competitive. This is 'business as usual'.