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The Inflation Debate

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For the first time in decades, New Zealanders can look forward to low inflation, a prospect many workers, consumers and business people have never experienced.

The fight against inflation has been a test of nerve and will. It is not over yet. However, I believe the hard part of the war is behind us and the ground phase could be relatively short. We must then apply ourselves to keeping the inflation peace.

Many have argued that the price of the inflation war has been too high. There have been persistent calls from appeasers wanting to call it off. It is true that there have been casualties along the way. But to yield to the temptations of appeasement would have been no less disastrous than a decision by President Bush to yield to the clamourings of the peace movement. Inflation can wreck economies no less surely than Saddam Hussein.

It may be interesting to take a glance at the history of inflation. It is worth noting first that inflation cannot exist in a barter economy. Inflation, through the debasement of coinage or the printing of paper, has only been around since money was invented and monopolised by governments.

The first recorded incidence of inflation involved the clipping of coins to reduce the weight of the gold and silver they contained. This theft was very obvious and people quickly caught on to the process – until paper currency was invented. With this new medium of exchange, and the development of central banks, governments were in a position to secretly appropriate large amounts of wealth from their citizens. The blame for this loss could be placed on the productive sector of the economy which "continually raised prices" to offset the loss from a depreciating currency.

As currencies depreciate, so do societies. To quote one writer:

> "The uprisings of 1789 cost Louis XVI some prerogatives, but four years later a valueless currency cost him his head. Germany's inflation of the 1920s laid the foundation upon which Hitler built. Indeed a runaway inflation is the goal of revolutionists. The maxim of that apostle of revolution, Lenin, was 'Debauch the currency!' "

Those who regard these episodes as historical curiosities would do well to note the contribution of worthless currencies to the disintegration of the Soviet Union and other Eastern bloc countries. Arguably too, the erosion of Mrs Thatcher's authority and standing with the British public was due in some considerable measure to the Lawson inflation of 1987-88. Having won office on an anti-inflationary policy in 1979 and reduced inflation from 18 percent in 1980 to 3.4 percent in 1986, Mrs Thatcher's government blinked. The experience of presiding over an inflation rate which reached 11 percent again in late 1990 damaged her prestige. As John Major put it, referring to the British government's misjudgment at the time of the sharemarket crash:

> "In retrospect, we relaxed [monetary policy] precisely at the moment when we should have made it more severe".

No manager or investor who is under 40 has any experience of working in a low inflation New Zealand. It was not always like this. Mild deflation, not inflation, was the order of the day in New Zealand in the 50-year period from 1860. Notwithstanding some difficult times and the excessive borrowing of the Vogel era, this was a period of remarkable economic progress. By the turn of the century, New Zealand's per capita incomes were around the highest in the world. By itself this experience turns on its head the argument that aiming for price stability is a recipe for economic stagnation.

Perhaps even more graphically, interest rates on New Zealand public borrowings of 3 to 6 percent were common in the last half of the last century and the average interest rate on new mortgages varied in the 3 to 7 percent range from 1920 to 1967. The days of 3 percent Post Office savings accounts may seem a quaint aberration to many of us now, but it is the last 20 years which is the aberration from this historical perspective.

The Deputy Governor of the Reserve Bank of Australia was recently quoted as saying:

> "Prices in Australia in the past two decades… have increased by about five times... I personally don't find that a performance that, as a central banker, I am very proud of."

In the period since 1967 in New Zealand, prices have increased not five times but ten times. Ours has been just about the worst inflation performance of the OECD economies.

It is no accident that over the same period other indicators have confirmed a story of poor economic performance. Most of us in this audience can remember when one New Zealand dollar bought much more than one Australian or United States dollar. In the early 1970s, one New Zealand dollar bought 400 Japanese yen. Now it buys 80 yen, one fifth of that amount. Note that these trends in the exchange rate bear no relationship with the path of interest rates as is often supposed. Beyond the short term, interest rates and the exchange rate are driven by quite different factors.

In New Zealand there has been zero growth in real wages since 1960 – an extraordinary statistic – whereas even in Australia and the United Kingdom wages rose by 70 percent in that period, and by 170 percent in Japan. A useful summary statistic in the latest OECD report on New Zealand is that from 1975 to 1988 New Zealand's per capita GDP slipped from 97 percent of the OECD average to only 74 percent – nearly a 25 percent fall. Yet in that time we were – and still are – continuing to live beyond our means.

The president of the prestigious American Economics Association stated in 1984 that there was no doubt that inflation had been the most important source of economic inefficiency in Pacific Basin countries in the previous two decades. The litany of costs associated with inflation is a long and familiar one. Inflation creates uncertainty in business planning, it shortens investment horizons, it raises the cost of long term contracts, it distorts the tax system, it increases real interest rates, it puts the competitiveness of exporters at risk, it erodes retirement savings and it leads to arbitrary and capricious redistributions of income. In essence, a market economy depends on the price mechanism to function properly and inflation stops it from doing its job well.

There are still some myths in the inflation debate that need to be laid to rest.

The most persistent myth is that the pursuit of a low inflation policy condemns us to low growth. As we have seen, this has it exactly backwards. While other factors were also relevant, New Zealand prospered when prices were stable and stagnated under inflation. The reason is the pervasive distortions to the economy that I mentioned. With lower inflation in the 1980s, most OECD countries experienced an unprecedented expansion. A resurgence of inflation and a tightening of policies has temporarily curbed this expansion – the cost of reversing an inflationary trend is another of the costs of letting inflation get out of hand. As the President of the Federal Reserve Bank of New York testified to Congress last year:

> "Virtually every observable facet of economic and financial history - here in the United States and around the world - tells us that high and / or rising rates of inflation are simply incompatible with sustained economic prosperity".

A related myth is that low inflation comes at the cost of high unemployment. This idea is a hangover from Keynesian economics that is widely discredited today. I am told it is now hard to find a Keynesian economist under 40 in the United States - although they still exist in the ranks of our universities and Radio New Zealand commentators. It is not difficult to find examples of low inflation, low unemployment countries like Japan and Switzerland. A poor unemployment performance can usually be traced to a rigid labour market and / or a welfare system that encourages people to opt for benefits rather than paid work. Over the longer run, inflation tends to be associated with higher, not lower, unemployment. A more valid observation is that the process of disinflation can be more costly in terms of unemployment in economies which lack structural flexibility.

A third myth is that inflation is mainly a problem when it exceeds the rates of our trading partners, and that achieving an inflation rate equivalent to theirs is an acceptable target. But as we have seen, a loss of competitiveness is only one of the many costs of inflation. Regardless of how other countries perform, inflation is always, without qualification, a bad thing. I doubt whether many people would regard an unemployment target equivalent to the average of our trading partners – say 6-7 percent of the labour force – as a good idea. An inflation target derived in this way makes no more sense. In any event, an increasing number of our trading partners seem likely to move towards a price stability objective in the 1990s. The Liberal Party in Australia, which may well form the next government, is committed to a zero inflation target.

Most commentators pushing for the abandonment of the 0-2 percent target believe the costs of that target to be too high. But the cost of an anti-inflation monetary policy is directly related to the divergence of inflation expectations from actual or target inflation. It is naive to believe that increasing target inflation to the average of our trading partners will not also increase inflation expectations. It is hard to see how the costs of an anti-inflation policy in that situation will be lower. Indeed, with New Zealand's track record on inflation over the last two decades, investors would have every reason to believe that the Reserve Bank would not stick to a higher target. While inflation expectations remain around 5-6 percent, the Reserve Bank must continue to lean against inflation. The adoption of a target linked to inflation in our trading partners would make little difference to its stance in present circumstances.

A fourth myth is that New Zealand cannot achieve low inflation if inflation in our trading partners is running at higher levels. But this is exactly what low inflation countries like Switzerland, Germany, Singapore and Japan have done. This is a myth that has survived from the era of fixed exchange rates. One of the benefits of floating currencies is that an economy does not have to import inflation from the rest of the world.

Fifthly, it is worth noting that gearing monetary policy to a target of 0-2 percent inflation, once achieved, does not require any greater ongoing monetary pressure than gearing it to a target of, say, 5 percent per annum. The main difference is that, technically and politically, any arbitrary target other than a stable price level is difficult to defend.

A final myth is that relaxing monetary policy would get us lower interest rates. The truth is that it would do nothing of the sort. Looser monetary policy could well lower short term interest rates but long term rates would almost certainly rise, and promptly, as markets anticipated higher inflation further down the track. This pattern was demonstrated clearly in Australia last year. It is long term rates that are most important for capital investment and household mortgages.

As the virtues of low inflation were rediscovered by many countries in the late 1970s and early 1980s, so too was an understanding of its causes. In essence, these are encapsulated in the old definition of inflation: too much money chasing too few goods. Price increases can be triggered by higher oil prices or a wage push but they cannot by themselves lead to inflation, that is, ongoing increases in the general price level. The recognition of the monetary origins of inflation has put monetary policy at centre stage in the fight against it. The essential injunction to policy makers is: "don't print money".

As a consequence, OECD central banks have been in the forefront of the fight against inflation since the early 1980s. Policy makers have come to recognise that the only useful role for monetary policy is to achieve and maintain stable prices. Often it has been a lonely and unpopular role. In economies where inflation has become entrenched, there is no costless way to eradicate it. The inflationary expectations of firms, wage earners and investors are hard to change. They are prolonged when the anti-inflation policies of a government lack credibility because monetary policy is not backed up by sound fiscal and other policies. The upshot is often a period of high interest rates, high unemployment, a high rate of business failures and economic and political instability. Nevertheless, countries that have stayed the course have gained the benefits, and ways of reducing the transitional costs are now widely understood.

One way of increasing the credibility of an anti-inflation programme is to strengthen the independence and accountability of the central bank. The merits of moves in this direction in New Zealand are confirmed by some international evidence. As summarised by *The Economist* recently:

> "By and large, the freer the central bank, the lower the inflation rate. Nor was this achieved simply at the cost of higher unemployment. Why? Perhaps because the policy credibility provided by independence speeds up the adjustment of prices and wages to the monetary climate, and thus minimises job losses."

One of the costs of disinflation that has attracted much comment and criticism is the high level of interest rates. At this juncture, two points in particular are worth making on this issue. One is that nominal interest rates in New Zealand have fallen substantially as inflation has subsided, and there are good prospects of further falls over the coming year. However, real – that is inflation-adjusted – interest rates remain some 2-3 percentage points higher than in some OECD countries. This premium is entirely due to the risks which financial markets perceive to be associated with lending to New Zealand.

An important part of this risk, which has recently been reflected in a further downgrading of New Zealand's credit standing, arises from the poor management of the government's finances which has led to the present crisis in government spending, borrowing and debt. Another part is our inflation performance itself, and the risk of currency depreciation which investors see as linked to it. A recent study by the Federal Reserve Bank of New York found that the capital cost advantages enjoyed by Japanese and German companies reflected the success these countries had achieved in preserving low inflation and hence a low risk premium in both short and long term interest rates. Countries with the lowest rates of inflation over time have the lowest market interest rates and countries with the highest rates of inflation have the highest interest rates. Those who want lower interest rates should support, not oppose, the Reserve Bank's policies.

There is a lesson here for groups like the Manufacturers Federation and government backbenchers who have called for looser monetary policy and lower interest rates. These calls achieve the opposite of what they intend. If financial markets believe they will be heeded, they will factor in an additional risk premium on investment in New Zealand. As *The Economist* pointed out recently in response to similar calls from British industry and Tory MPs:

> "In the early 1980s, when the French government was periodically devaluing the franc within the EMS, French short-term interest rates were seven to eight percentage points higher than German ones. Today, the difference is less than one point. The gap has narrowed because the French have long since accepted EMS disciplines, and cheaper money (as well as lower inflation) is their prize. That same prize will elude the British for so long as they yearn for it publicly. Careless talk costs jobs."

The absence of a German or Swiss political consensus on inflation means that financial analysts in New Zealand spend an inordinate amount of time monitoring the possible implications of dissension in party ranks, and markets remain nervous. Any sign of policy weakening which would increase the risk of higher inflation drives interest rates up.

I suggested earlier that the war against inflation is being won. In calendar 1990, prices in New Zealand moved up by 4.9 percent compared with 6.9 percent in Australia. Over the past three years New Zealand prices (excluding GST) increased by 16 percent compared with 24 percent in Australia. Favourable factors at present include falling oil prices and interest rates and lower wage increases. Some analysts are predicting inflation will be only about 1 percent in the first six months of this year and could hit a 25-year low for 1991 as a whole. Provided wage movements stay within the declining inflation path and there is no precipitate fall in the currency, we are on track towards the 0-2 percent target for 1993.

I would like to think that the inflation debate is also coming to an end. Most people now understand that you can't get more goods and services simply by printing money. Our cost and price competitiveness is steadily improving through a favourable inflation differential with many of our trading partners and significant improvements in productivity. The Reserve Bank has indicated it would not stand in the way of some nominal depreciation, provided this was associated with the maintenance of a firm monetary policy and resulted in the necessary reductions in real wages and other real incomes. The last factor is critical: too many of those who clamour for devaluation do not seem to realise - or are not honest enough to acknowledge - that they are implying a need to cut wages in real terms.

Most recently the Porter study has also reminded us that competitiveness is not only about price and cost factors, but also about innovation, improved product mixes, better skills and more inspired business strategies, features which are lacking in many of our producer boards and other export firms.

The recent OECD report on New Zealand concluded that:

> "...continued progress needs to be made on achieving price stability. Fiscal consolidation should be pursued vigorously, concentrating on expenditure reductions. The process of microeconomic reform should be continued, particularly in the labour market... To build on the reforms of recent years and to underpin the much-needed improvements in the country's medium term growth prospects, it is essential for New Zealand to consolidate and extend the policy orientation pursued since the mid-1980s."

This prescription is fully in line with the analysis of the Business Roundtable and many other New Zealand organisations. It has been endorsed by the present government. The government's moves on expenditure have facilitated a decline in interest rates and it is already clear that there is massive upside potential for firms, workers and especially the unemployed from the new employment legislation.

If this programme is adhered to, I hope we shall hear less and less from the inflation appeasers. In a *Herald* opinion survey taken last year, a majority of those polled supported the low inflation target of 0-2 percent. Younger voters supported it more strongly than older people. German and Japanese electorates punish governments that are soft on inflation. Preserving the value of the currency should be put on a par with preserving the value of other weights and measures. I do not fancy the prospects of those politicians, whether young Turks or old Turks, who would settle for a 5 percent inflation rate when they front up to their electorates with the proposition: "Vote for me and I will support a policy which will double prices over the next 14 years." Even the Manufacturers Federation favours a 3 percent inflation target. If that is the extent of our differences, what is all the fuss about? Manufacturing businesses like my own should be major beneficiaries of the more stable and competitive environment which we can look forward to in the next few years.

The Porter study argues that we should call an end to the debate about inflation and devaluation and take as read the need for a stable macroeconomic environment.

Politicians have better things to do with their time, wage negotiators can focus on real factors that should determine wages, and retailers can cut down on changes in price labels in their shops. Instead governments should concentrate on upgrading New Zealand's skill base, stimulate competition from domestic and international sources, promote immigration, remove monopoly controls on state enterprises and producer boards, cut government spending, deficits and debt and reform superannuation and welfare policies. According to Porter, businesses for their part should move beyond cost-based strategies, become more knowledgeable competitors, focus more on innovation, invest in human resource development, adopt a more global approach to strategy and match themselves against the world's best rivals.

I think he's right. I hope enough people out there are listening.