"An opportunity to get the fundamentals right"

A discussion of the consequences of inflation targeting in a small open economy, the New Zealand experience, and changes required going ahead.

presentation to IPS Economic and Social Policy Symposium

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Business and Economic Research Ltd

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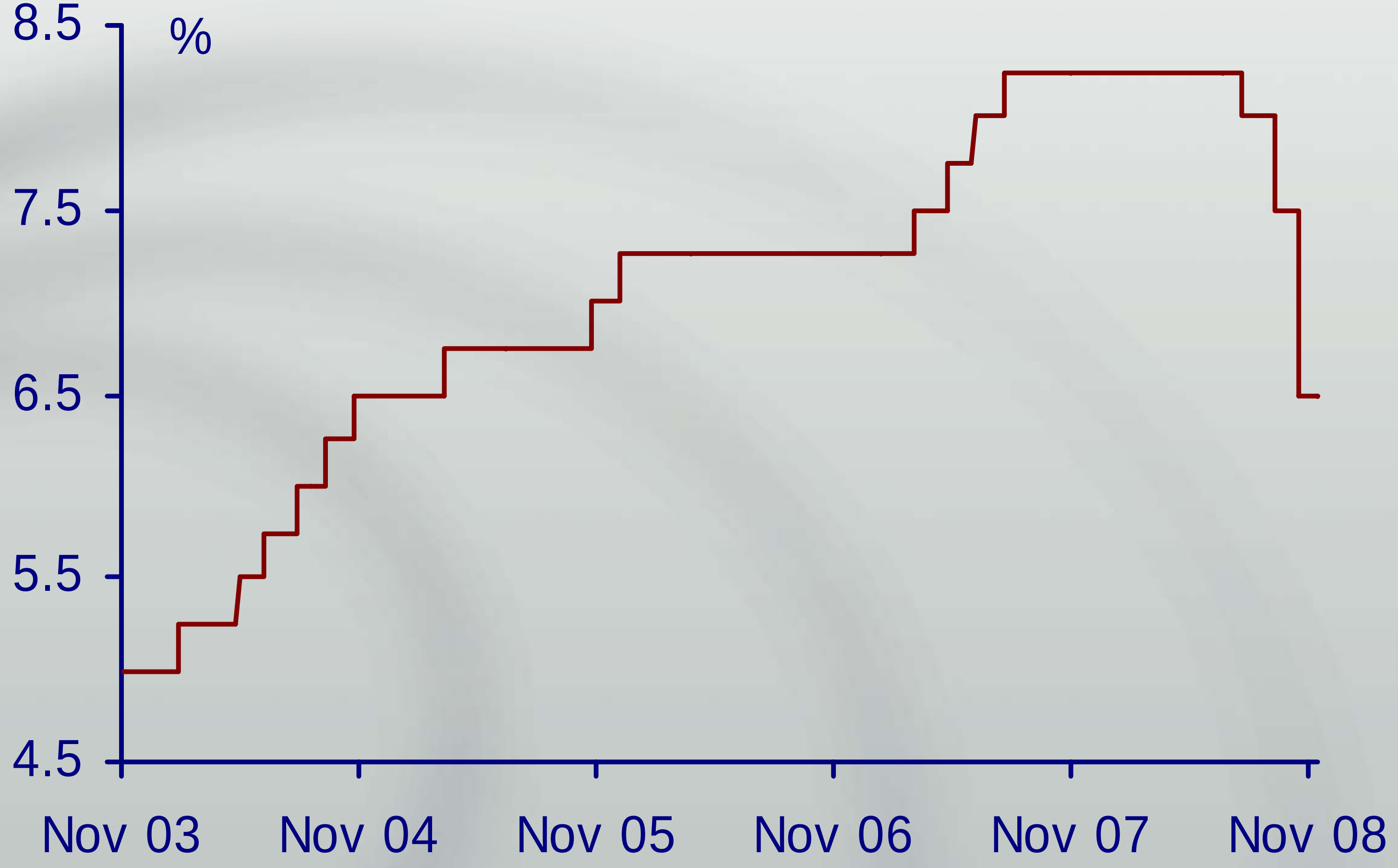
Agenda

- NZ’s recession
- 20 years of inflation targeting
- the low-wage cul-de-sac
- the exit strategy

NZ OCR



The recession

RB *Monetary Policy Statement* June 2008

March years	2008	2009	2010	2011
GDP production	3.1	0.9	1.4	2.5
Employment	-0.2	-0.2	-0.4	0.0

“The length of the downturn is in part required to keep medium-term inflation under control”

BERL Forecasts June 2008
Editorial

"... a state agency can publish an economic forecast ... of four consecutive years of negative or nil employment growth and yet no one has been called to account to explain such a comprehensive failure of economic policy."

BERL Forecasts June 2008
Feature: the costs of low inflation

over the coming three years:

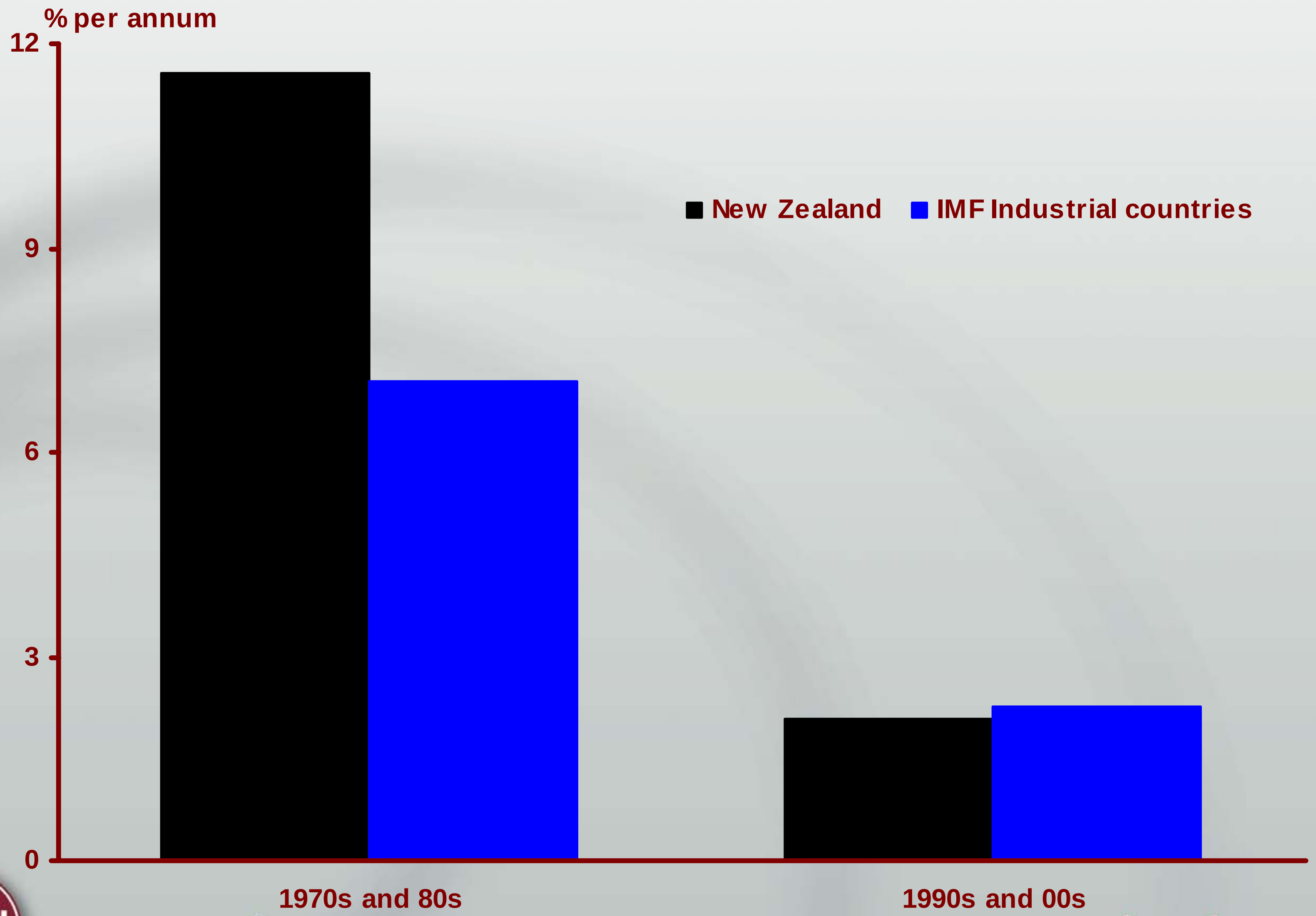
- an additional 44,000 unemployed, and
- a further 51,000 remaining outside the labour force
- that is, 95,000 jobs
- equivalent to $7.4bn of GDP
  - * or the size of the entire agriculture sector's annual contribution.

BERL Monthly Monitor October 2008

"... the recession was engineered ... as a result of the policy framework that puts the costs of heightened inflation above those of recession. ...

Unfortunately, ... our timing could not have been worse."

Annual average inflation



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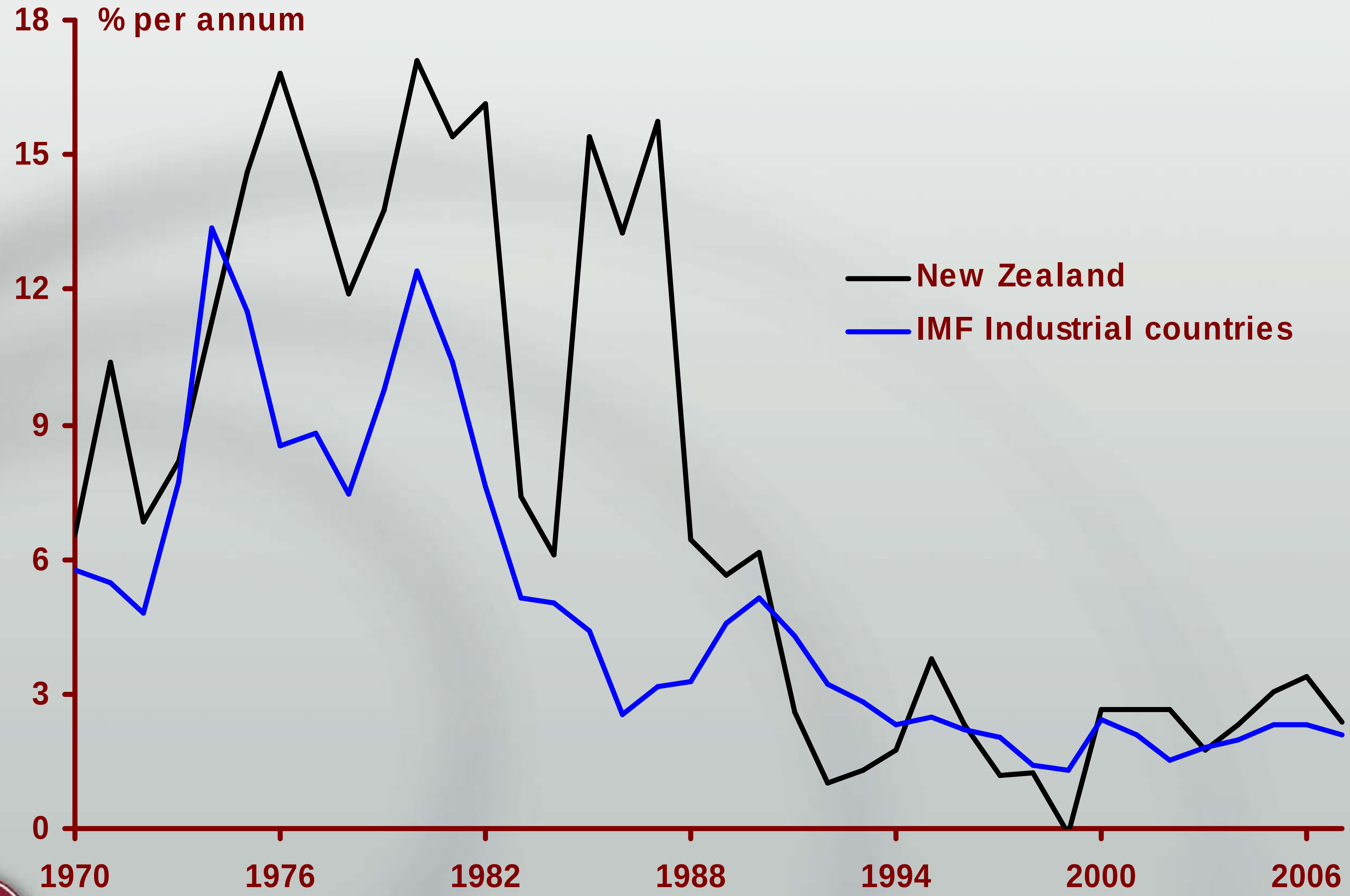
Annual inflation



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20 years of price stability

The Kiwi $

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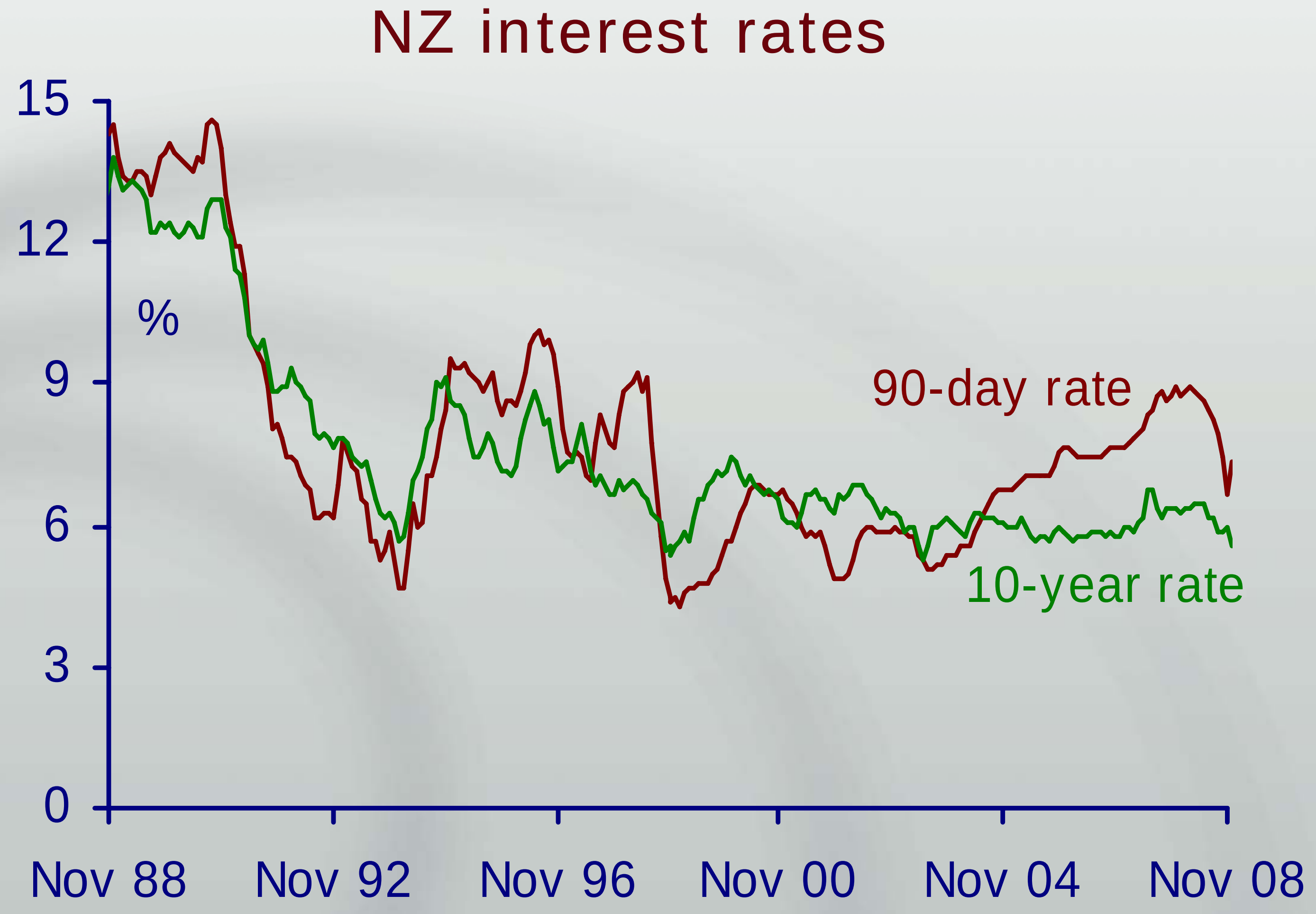
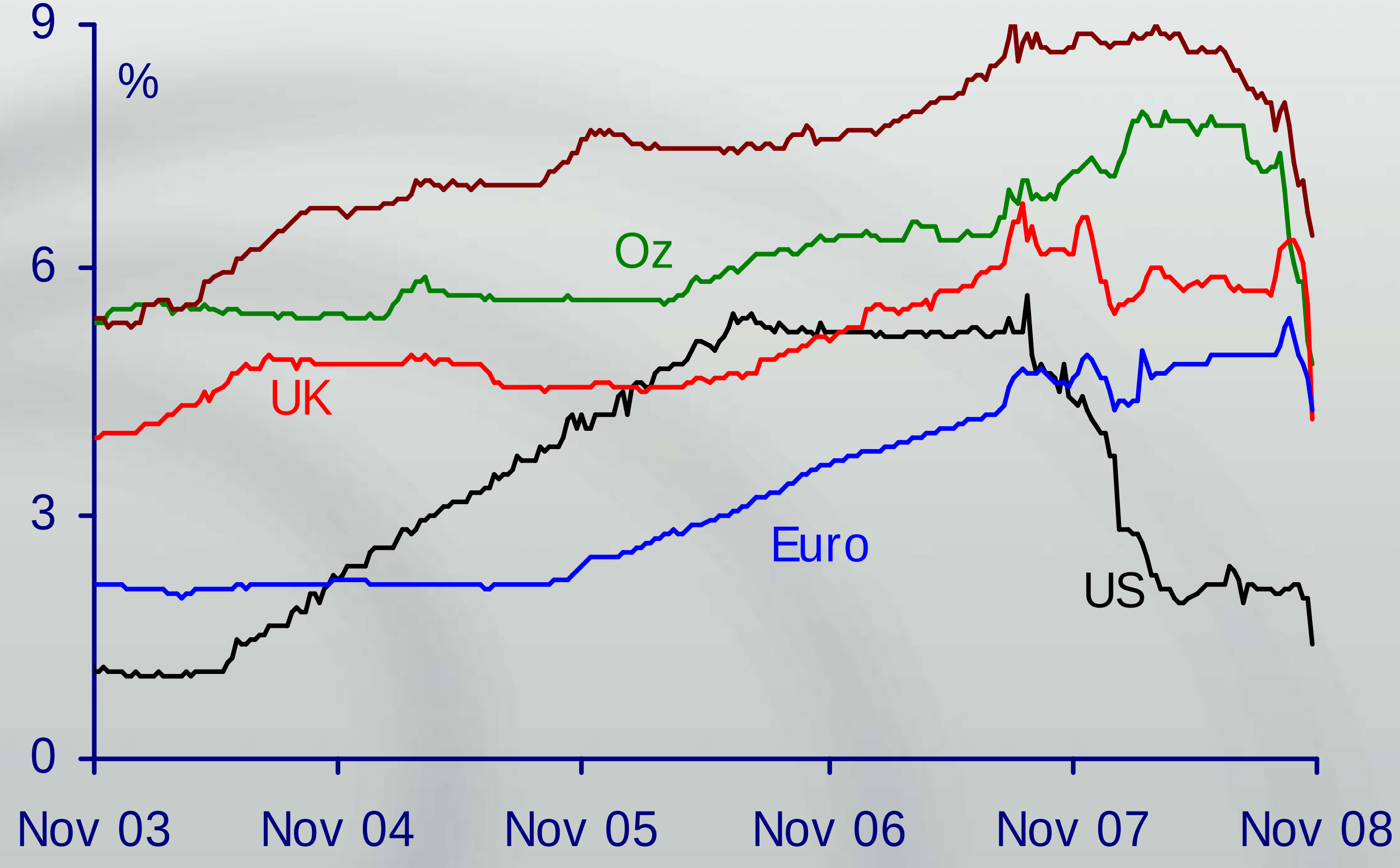
20 years of price stability



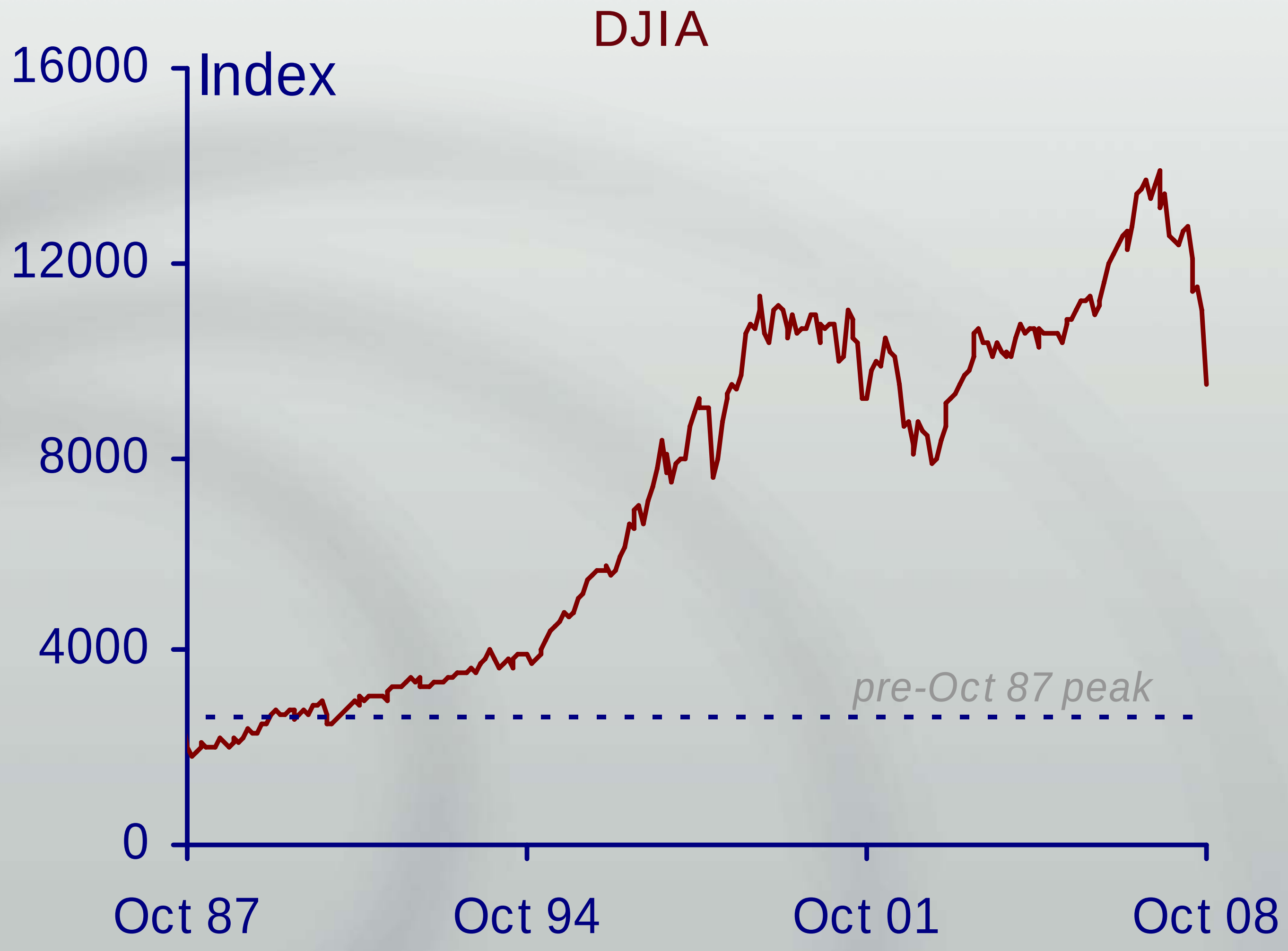
90-day interest rates



20 years of price stability

NZX50*

US share prices



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Australian share prices

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The cul-de-sac

RBNZ forecasts higher inflation

RBNZ increases interest rate

Spending increases

NZ money supply increases

Foreign funds attracted

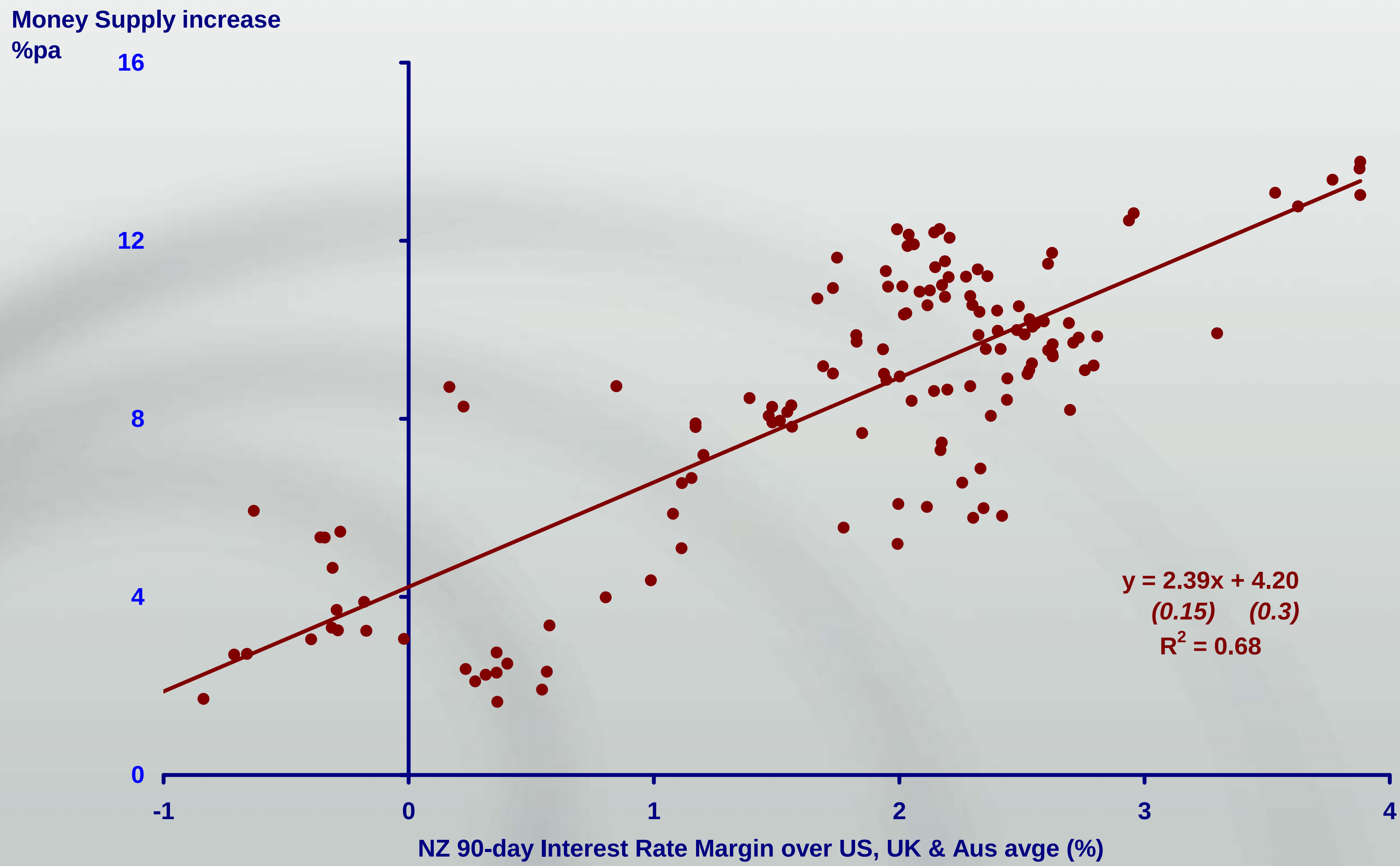
House prices increase

More careless lending

NZ$ exchange rate increases

Financial failures

Money supply growth and NZ interest rate margin



1% interest margin *caused(?)* a 2.4% increase in money supply??

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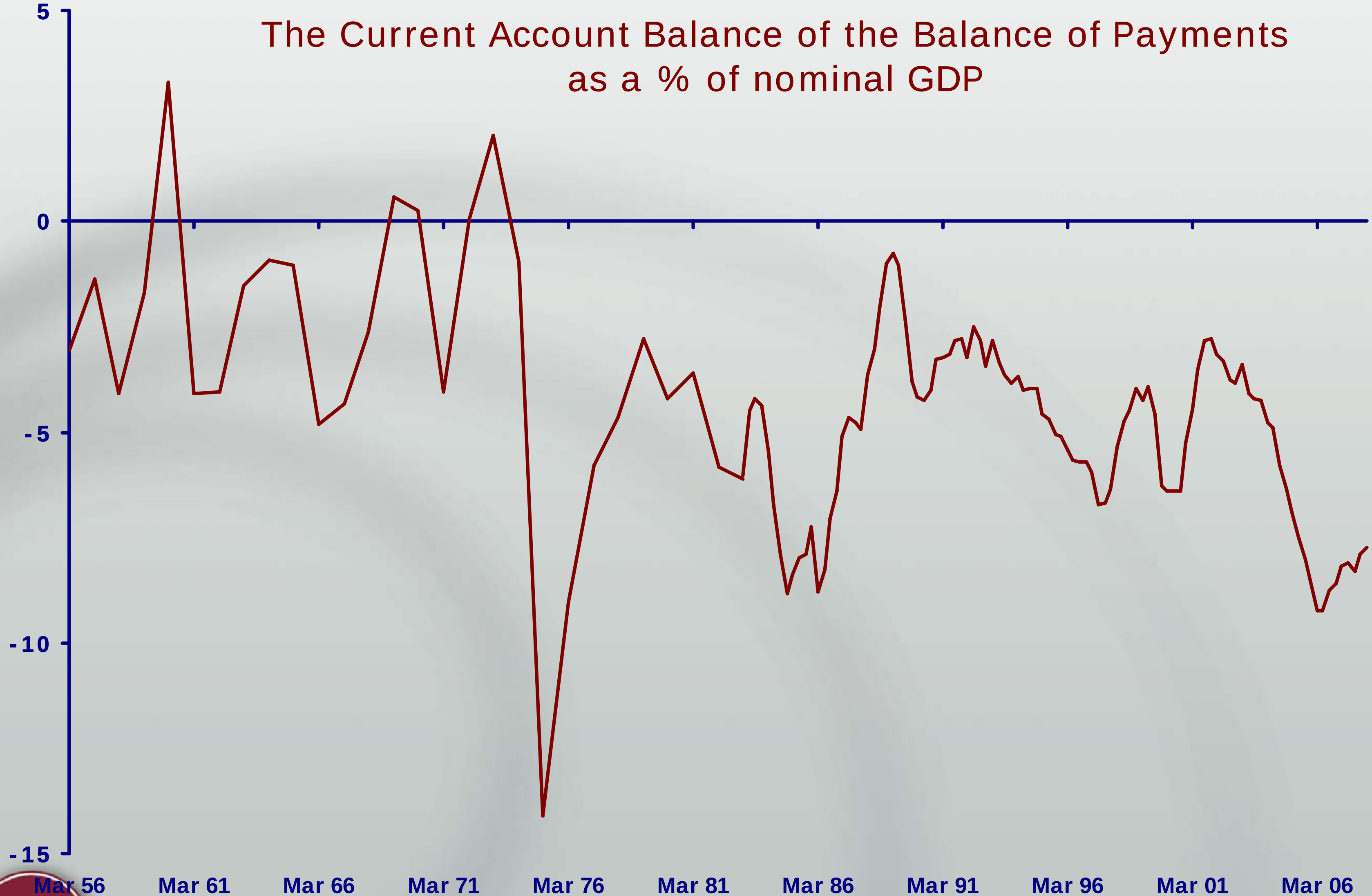
GDP per capita

in US 2006$s	1973	2006
New Zealand	16,732	23,362
Australia	16,802	30,466
OECD average	14,732	27,184
United States	20,312	37,572

The Achilles' Heel of the NZ Economy



Economic transformation the Kiwi way

External trade volumes as % of GDP

20 years of inflation targeting: a report card

The Benefits

Low consumer price inflation	✓

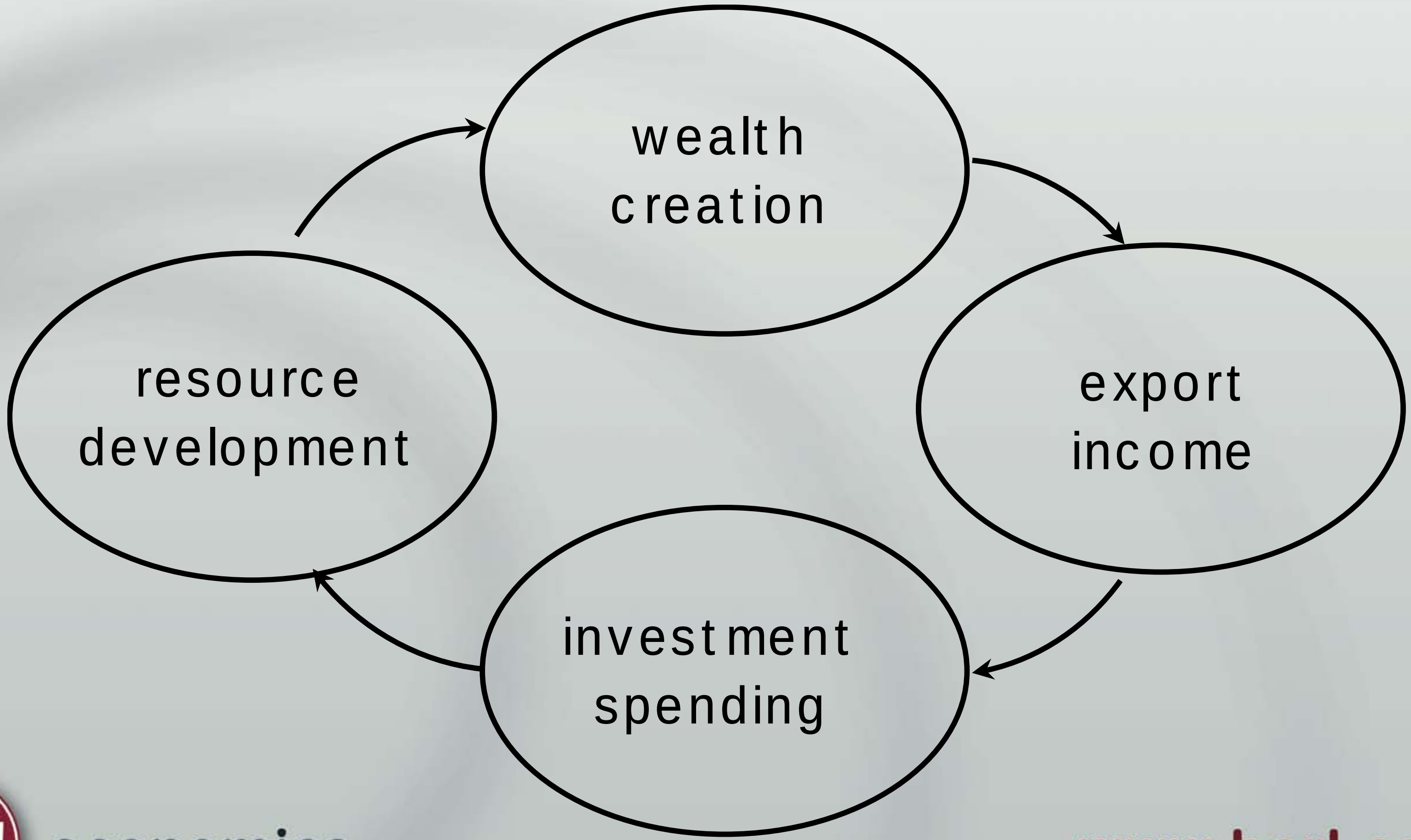
The Costs

Other prices	Interest rates	✗
	Exchange rate	✗
	Assets: equities, houses, farms	✗
Sustainable investment and productivity growth		✗
Sound financial system		✗

Spot the difference

A lesson in rocket science

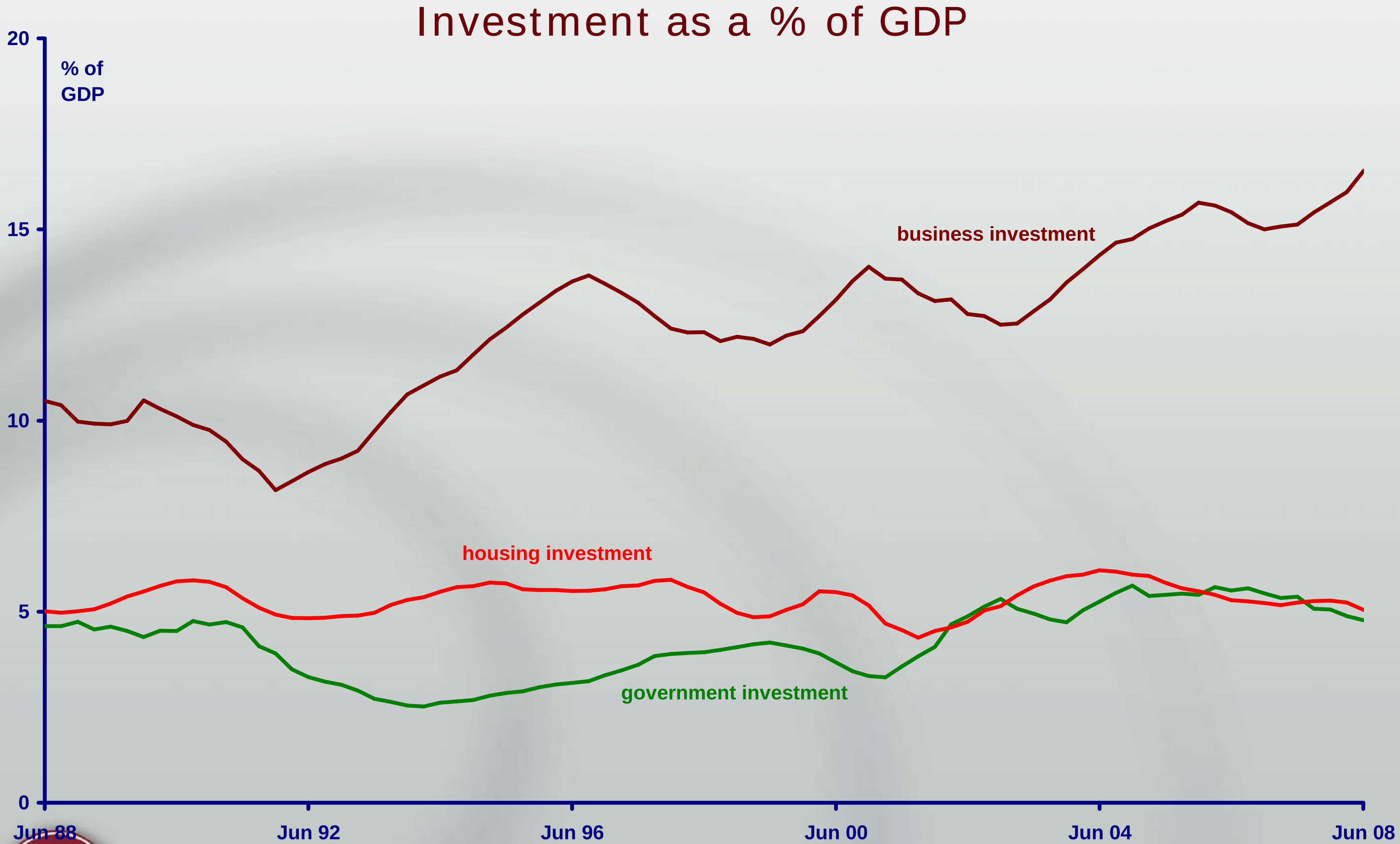
or Economics 101



2 key prices

- price of borrowing
  * no, not for houses – but for long-term investment in business growth
- price of foreign exchange
  * so that exporting is profitable to engender wealth creation through attraction (and retention) of resources

How much are we investing for the future?



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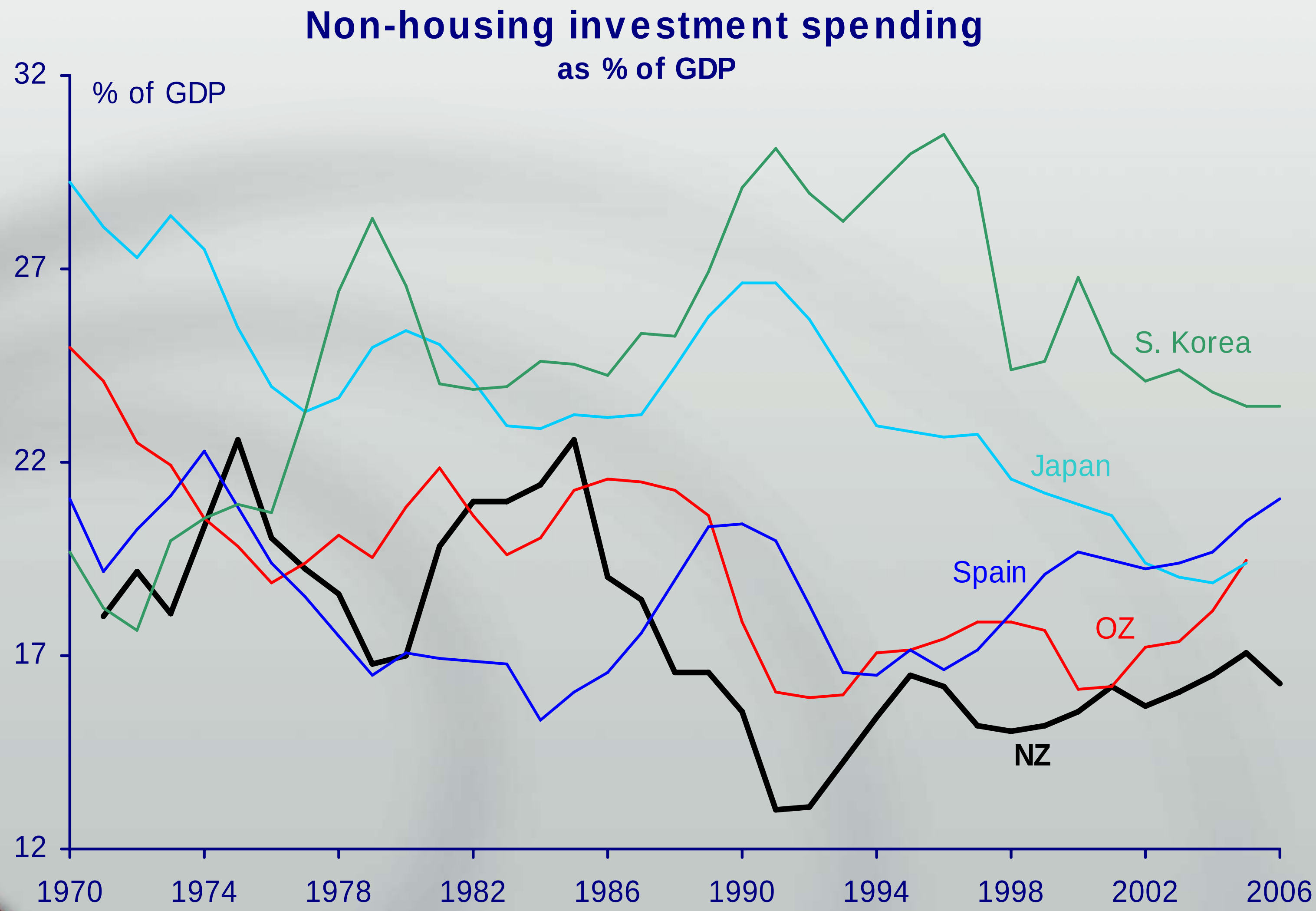
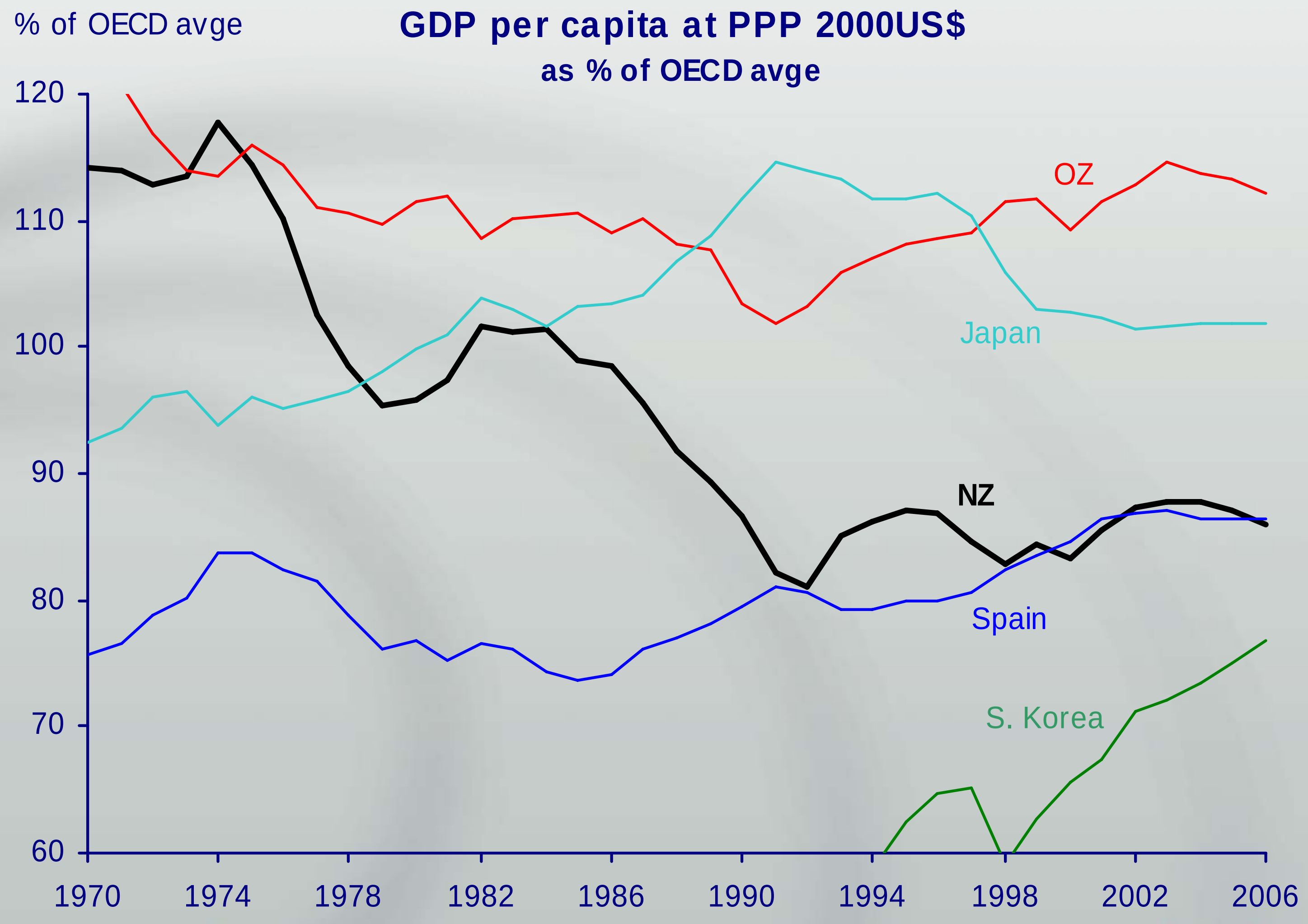
Is it enough?


Non-housing investment spending
as % of GDP
% of GDP
32
27
22
17
12
1970
1974
1978
1982
1986
1990
1994
1998
2002
2006
S. Korea
Japan
Spain
OZ
NZ

What about investment in people?

- Of NZ's 20-40 year olds more than a quarter of a million (268,000) have, AT BEST, a level 1 qualification
- and, remember, the majority of these will remain in NZ's labour force for the next 20 years (if not longer)
- this group will play a significant role in NZ's productivity performance for the next 20 years (at least)

Because, look who's catching up



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NZ's merchandise terms of trade

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Responses to a recession

"Deficit hawks have preached the notion that fiscal austerity – cutting expenditures and raising taxes – will restore confidence, and this will in turn restore economic health.

Rejecting the overwhelming evidence that expansionary fiscal policy is the medicine needed in an economic downturn, they have echoed the chorus that Keynes is dead."

from "The Roaring Nineties" by Joseph Stiglitz
World Bank Chief Economist 1997-2000
Nobel Prize for Economics 2001

Responses to a recession

'Both developing and developed countries need to abandon inflation targeting. The struggle to meet rising food and energy prices is hard enough. The weaker economy and higher unemployment that inflation targeting brings won't have much impact on inflation; it will only make the task of surviving in these conditions more difficult."

Joseph Stiglitz
World Bank Chief Economist 1997-2000
Nobel Prize for Economics 2001

“Today’s dirty word is inefficiency, not profit. We are not rich enough to accept inefficiency of any form. We cannot afford to misuse our resources of labour, capital, land and entrepreneurial talent.

“The Government is not seeking growth at all costs, but a faster rate of growth is nevertheless our goal. … Without growth in output the prospects for raising real incomes and for employment are bleak.”

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Budget Speech, July 1980