MEMORANDUM FOR	Monetary Policy Committee
COPIED TO	
FROM	Michael Reddell
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SUBJECT	FISCAL POLICY, MONETARY POLICY AND MONETARY CONDITIONS: 1990 AND 1991

Executive Summary

The interplay between fiscal and monetary policy in New Zealand over 1990/91 has received considerable attention over the years, being used by many (here and abroad) as an example to prove a number of (often conflicting) points or interpretations, about economic history and economic policy. This note is intended to explain what happened during that period and what role the Reserve Bank played. It is a complex story, and perhaps all the harder to interpret simply in the language of today's debates because the political environment and the way we ran (implemented) monetary policy were all so different from what prevails today.

The overall story was one in which both confidence effects and short-run demand effects were in play. It was also one in which the direct price effects of the exchange rate were much larger, and played a much larger role in policy thinking. The Bank was fairly consistent over the period in taking the view that looser (tighter) fiscal policy might be expected, all else equal, to lead to tighter (looser) monetary conditions, even if the public articulation varied through time. The Bank was highly focused through this period on the "need" for a sustained reduction in the real exchange rate, initially much to the chagrin of The Treasury and the incoming Minister of Finance.

The Bank also went through various degrees of coordination and consultation over the issues with successive governments, and repeatedly debated internally how closely to tie ourselves to government actions. At no point was there any sort of "deal", in which the Bank undertook to ease policy if fiscal policy was tightened "enough", but equally the overall thrust of the framework meant that, all else equal, we operated in that way - as, in effect, we have done ever since. That was the nature of the framework. [redacted] Withheld: OIA s9(2)(f)(iii)

Introduction

The way in which fiscal and monetary policies interact has come back into focus globally in the last couple of years, with considerable focus on the extent to, and the circumstances in, which fiscal consolidations will adversely affect the short-run path of economic activity.

Some have argued that the New Zealand experience in the early 1990s is one example that helps shed some light on the issue. Some have even gone so far as to cite New Zealand as evidence for the possibility of the fabled "expansionary fiscal contraction" [1]. The current quite severe New Zealand structural fiscal imbalances also provide some background context.

This note is intended to help explain what happened during the 1990/91 period, and what role the Reserve Bank played. It draws on material written at the time[2], as well as trying to stand a little further back and view events through the sort of lens we might use today.

Some context

To understand how things unfolded during the period from mid 1990 to late 1991, it is important to bear in mind several things:

- The Reserve Bank Act had only come into effect in February 1990, and the first PTA was signed on 2 March 1990. The legislation, with its combination of formal operating autonomy for the Bank and a single monetary policy goal of price stability remained highly controversial. It was controversial within both main parties. The National Party had a large lead in the polls throughout 1990, and within National caucus prominent figures such as Sir Robert Muldoon and Winston Peters (the latter at times polling more highly than his leader) were staunchly opposed.

- Bank senior management had placed a high priority on safeguarding the framework itself, [redacted] ie nothing active to drive the inflation rate further down.

- Core inflation was still well above the 0-2 per cent target range. We forecast inflation for 1990 in the "indicative target range" of 3-5 per cent.

- Economic activity had been pretty subdued since at least the 1987 share-market crash.

- We did not directly set an official policy interest rate, but managed monetary conditions through a combination of statements, nudges and winks, and occasional adjustments in technical parameters such as the target level of settlement cash and the terms on which we would provide additional cash to counterparties. Dysfunction in the cash market at times prompted remedial actions and statements from the Bank, which were at times hard to disentangle from comment on the stance of monetary policy. At times, communications was a major problem - at one point in 1990 the Opposition spokeswoman on Finance memorably compared our efforts with Fawlty Towers.

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[1] See, for example, the link to Roger Kerr's interpretation at http://www.marginalrevolution.com/marginalrevolution/2010/06/ruth-richardson-and-fiscal-austerity.html

[2] This includes (a) published material, such as *Monetary Policy Statements,* (b) the slightly ad-hoc collection of clippings, papers, old e-mails I collected through this period that are now in the Bank's archives (the A0-100-100 series, Mike Reddell's Closed Files) and (c) my contemporary diaries.

- The direct effect of exchange rate changes on the CPI was, and was regarded as being, much stronger than it is today. In the late 1980s we were using an estimated CPI equation with a pass-through to consumer prices from the TWI of .46, and even by 1990/91 we were still working on an assumed pass-through of in excess of .3. For any given economic outlook, that made us very sensitive to changes in the exchange rate, the more so because there was no sense that the direct effects of the exchange rate might be able, in appropriate circumstances, to be "looked through" for accountability purposes.

- From around the end of 1988, monetary conditions were being managed with reference to "indicator bands" for key financial market prices. For most of the period, the exchange rate band was most prominent, but for an important period in 1991, the yield gap (between 90 day rates and 5 year government bonds) moved centre-stage. These bands were not intermediate targets, and were reviewed each quarter in light of our assessment of the economic situation and the inflation outlook. The framework was, however, open to misinterpretation and was highly controversial in some circles (it was perceived by some, including the National Opposition, that we were (medium-term) targeting the exchange rate). Bands that were breached, thus prompting action, could be deduced by the market, while those that were not (eg the yield gap during 1990) could not.

- There was a very significant focus in both the Bank and Treasury on being able to establish credibility for the ongoing reform programme, through achievement of measureable targets. Hence, for example, although the PTAs were expressed in terms of 0-2 per cent inflation by, first, 1992 and then 1993, the Bank had published indicative intermediate ranges for inflation, designed to help strengthen credibility.

- Relations between the Bank and the Treasury had for some time been quite tense[3] over a variety of debt management, cash management and monetary policy issues. The Treasury had for several years being trying to find a model of Reserve Bank governance that would enable the Bank to be held directly accountable for outputs rather than outcomes (to parallel the general approach in the State Sector Act). Some of that was reflected in the quite mechanical accountability provisions in the first PTA - any one-off price shock threatening the target range would involve the Minister in a renegotiation of the target. More generally, it left Treasury hankering for money supply or base mechanisms for monetary control, and reinforced their unease about the "checklist" approach to implementation that the Bank was adopting. In particular, they were very uneasy about the prominence of the exchange rate in the management of monetary conditions, influenced by various factors no doubt, but not least among which was the memory of repeated failed pegs and the 1984 devaluation. There had been a strong sense, in both the RB and Treasury, in the period immediately following liberalisation that no one had any good basis for interpreting the exchange rate or interest rates, or for judging where neutral or equilibrium levels might be. In parallel, though there was a sense that the real exchange rate had been materially overvalued

[3] Following the 1989 Budget, when the Minister of Finance had decided in favour of the RB position on a major debt management issue and gone against the Treasury position, [redacted] Withheld: OIA s9(2)(a) [redacted]

and needed to settle rather lower to achieve external balance at full employment, and facilitate strong growth.

- For several years, the Bank had been repeating almost ad nauseum a mantra that the disinflation process would be easier and less costly if there was more support in the form of more rapid fiscal adjustment, more rapid removal of trade protection, and liberalisation of the labour market. On this one, our messages were at one with those of Treasury (and of the Opposition National Party). Curiously, we were quite slow to recognise that in inflation and cyclically adjusted terms, the government accounts were already in surplus by the late 1980s.

The 1990 Budget

1990 was election year and the Government was well behind in the polls. A materially expansionary Budget ensued in late July, including a number of measures involving price/fee reductions, with attendant one-off benefits for the inflation rate. The reversal in fiscal direction, after five years of sustained consolidation[4], was compounded by the inclusion of privatisation proceeds (cutting rights on Crown forests) as operating revenue in an attempt to present the Budget as still delivering a surplus. Markets reacted negatively to the Budget, with bond yields rising and the exchange rate falling. The possible demand effects of the looser fiscal policy were not really the subject of much attention (internally or externally), perhaps partly because few people thought the government had a serious chance of re-election and so did not expect the initiatives in the Budglet to be implemented. Instead, markets appeared to focus on the sense that New Zealand p1olicymaking was losing direction again - investor attitudes having been successfully stabilised after the ousting of Roger Douglas at the end of 1988. The "cutting rights" issue was seen as symptomatic of the concerns.

The Bank's position on the issue was rather mixed. From an inflation targeting perspective, our initial internal reaction was to welcome the one-off price reductions, as assisting in the process of lowering medium-term inflation expectations, even while recognising the medium-term deterioration in the fiscal position. However, market reactions played a greater part in shaping our response. Bond yields rose in response to the Budget, and the exchange rate weakened, threatening the bottom of our indicator band for the exchange rate. Recall the importance of the direct exchange rate channel and the desire to ensure that the intermediate inflation bands were met. The market reaction prompted a fairly strongly-worded statement (and associated liquidity management action) from the Bank a few days later, intended - according to contemporaneous records - as both as a shot across the bows of fiscal policy itself, and more immediately in response to the exchange rate fall. Mortgage rates increased.

The Government did not appear to have anticipated the sort of market or RB reaction they got[5], and it made for a fairly testy few weeks. The Bank followed up in its September *Monetary Policy Statement* with these observations:

[4] The primary surplus in 1989/90 had been 4.5 per cent of GDP, well above anything plausibly required to stabilise the debt ratios.

[5] A point made in contemporary media accounts, and David Caygill has confirmed this recently.

(excerpt begins)

The third major imponderable which will affect New Zealand's economic performance over the next few years is the fiscal situation. After five years in which fiscal policy has made major strides towards bringing the Government's finances back into balance, the Bank was disappointed to observe the slippage evident in this year's Budget. The implications of that slippage have quickly been seen in higher interest rates as investors, already concerned about the possible policy outlook after the election, rerated New Zealand dollar assets downwards.

The Bank welcomes the stated commitment of both major political parties to the goals of price stability and fiscal balance. The case for price stability has been outlined earlier in the Statement. But the pursuit of fiscal balance is just as important a part of a balanced macroeconomic strategy. New Zealand still has a very high level of external debt. As a result, the nation remains particularly vulnerable to external shocks and, in these circumstances, it is incumbent on the public sector to ensure that its own financial deficits do not exacerbate that exposure. Also, an appropriate degree of fiscal restraint helps to ease the magnitude of the task facing monetary policy in the remaining years of disinflation. In particular, a supportive fiscal policy stance minimises the degree of pressure on real interest rates needed to achieve the desired degree of downward pressure on inflation.

(end of excerpt)

The Growth Agreement

Mike Moore toppled Geoffrey Palmer as Prime Minister in early September 1990. On 17 September, the government announced a "Growth Agreement" with the CTU, in which the CTU undertook to exert its influence to achieve wage settlements of 2 per cent (per annum) and the government undertook to take substantial steps towards reversing the deterioration in its fiscal position. Politics aside, the aim was to help lower interest rates and preserve employment by restraining wage increases. The Bank became involved because "the parties sought some assurance that the Bank would not step in to offset any falls in interest rates generated by the agreement"[6]. The Governor issued a statement in conjunction with the release of the Agreement welcoming the agreement somewhat effusively ("I am very hopeful that the cooperative spirit of the agreement will help to deliver the improvement in competitiveness that this country needs"), and making clear that if inflationary pressures (whether from wages or fiscal policy) receded, less pressure would be needed on interest

[6] Feb 1991 MPS, p25

rates. The Governor went as far as to state that "it is my view that today's commitments by Government and CTU leave scope for some easing in current monetary conditions"[7]

The Bank's association with this agreement generated some controversy, including criticism from the Opposition. In its defence six months later (the Feb 1991 MPS), the Bank noted that it had really been doing nothing more than reiterating a longstanding policy position. As the Bank notes, no one (inside or outside the Bank) put much weight on the fiscal lines in the Growth Agreement, but the Bank took the view that the Agreement had engendered a greater degree of wage restraint than had previously seemed likely, and to that extent the agreement had served a useful economic purpose.

Market sentiment remained very jittery in the run-up to the election: some of that was about politics; some about perceptions of the Bank's own commitment to the inflation target. Twice in two days the Bank felt the need to publicly reiterate its continuing commitment to price stability. Part of the issue was misunderstandings around the role of the exchange rate in the framework, after the Bank failed to react to the TWI falling to levels it had defended over the previous year. Failing to do so was, of course, consistent with having allowed a modest easing in monetary conditions following the Growth Agreement.

The Bank's Post-election Briefing

The Bank's Post-election Briefing was a substantial and wide-reaching document, with a focus on economic and financial policy issues, explicitly articulated as being written in terms of our role as a wider adviser on economic matters, not simply on managing policy under the Policy Targets Agreement.

In this document, the Bank put a lot of weight on the need to secure a sustained reduction in the real exchange rate, highlighting the likelihood of further large current account deficits and a further significant deterioration in the NIIP position. The Bank considered that the weak economic situation was conducive to allowing more adjustment through a fall in the nominal exchange rate, with only limited risk of a spillover into wage settlements and medium-term inflation pressures, and citing the favourable experience after the earlier (late 1988) fall in the exchange rate[8]. All that led us to advocate a change in the inflation target, to a 0-2 per cent inflation target by 1993 – thus leaving room for direct price effects to come through in 1991 and 1992. By happy coincidence this was also the manifesto promise of the National Party[9].

The document also set out the Bank's thinking on fiscal policy. In this discussion, short-run demand effects of fiscal policy moved back towards the forefront. The Bank noted that fiscal policy for much of the previous few years had been quite supportive of monetary policy, enabling the Crown to run inflation and cyclically adjusted surpluses from 1987/88 to

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7 The statement is reproduced on page 39 of the Feb 1991 MPS.

8 There was a huge degree of sensitivity around what the Bank was saying about the exchange rate, and a fear that we could spark a large and/or disorderly move. There was extensive and vigorous debate between the RB, Treasury and the Minister around the Bank's position on the exchange rate and unease around the idea that we might be sen as actively trying to promote a lower nominal exchange rate. The published version contained somewhat moderated language, and attracted little attention.

9 Until the very last minute we had been going to recommend more of a shift in the target (in effect a higher ceiling [redacted] Withheld: OIA s9(2)(a) [redacted].

1989/90. It noted that successful fiscal consolidation had spread the burden of disinflation more evenly across the economy and that "success in fiscal and monetary policy was mutually reinforcing and the overseas and domestic credibility of the reform and stabilisation programmes grew" (quotes are from pages 71-72 of the version I have).

That set the backdrop for noting how unfortunate the slippage in the 1990 Budget had been, noting the "lost credibility for the direction of the reform programme" and that "pressure came on interest rates and the exchange rate, and prospects for a sustained recovery in investment and growth were set back."

Turning to the way ahead, the document outlined the Bank's view as follows:

(excerpt begins)

> In view of the savings and balance of payments situation, we believe that it is critical, for domestic and overseas investor confidence, that the Government acts to set out clear directions towards a fiscal surplus. The Government's own debt levels are no longer a critical concern, being around or below the OECD average in 1990/91. However, the degree of exposure of the New Zealand economy to sudden changes in sentiment in international financial markets, arising from the large national external debt and continuing large current account deficits, argues that the Government should significantly improve its own savings record (over the 1991/92 outcomes projected at present), as part of a risk-averse adjustment strategy. Also, as fiscal circumstances permit, we would favour moving towards eliminating the distortions which discourage private savings.
>
> In our view, the achievement of sustainable cyclically-adjusted (and inflation-adjusted) surpluses would make the best contribution to help achieve price stability while helping to lower nominal and real interest rates, and to achieve a sustainable improvement in the balance of payments.

(end of excerpt)

Although the Post-election Briefing had been actively debated for weeks, and in some cases months, the tone of the key fiscal text was not determined until the morning, a few days after the election, of the day when the PEB was sent to the Prime Minister elect. My record of the final day includes this note: "We had a marathon session in Don's office (from 8-11) going thru para by para agreeing on a text…changed fiscal tack in favour of a tough stance now, to help cement-in any exchange rate depreciation [redacted] Withheld: OIA s9(2)(f)(iii) [redacted]". The extent of the actual deterioration in the fiscal outlook (including the bailout of the BNZ) became apparent in the days following the election. That deterioration further unnerved markets, and interest rates increased and the exchange rate fell.

The December 1990 package

On 19 December 1990, the new government announced a wide-ranging package of measures. These included the labour market reforms that became the Employment Contracts Act and the modification of the PTA to alter the target date to December 1993[10]. The focus of the package was on improving the overall "mix" of policies, with a particular emphasis on easing the pressure on monetary policy. The Bank's PEB was released at the same time.

The substantial fiscal measures (the benefit cuts being the best-remembered element) were the immediate focus of Bank interest. Those measures were intended to cut $2 billion per annum (3% of GDP) out of projected deficits over the forecast period.

In the period immediately prior to 19 December, markets had begun to anticipate a market-friendly package, and prices had begun to adjust accordingly, with interest rates falling and the (downward sloping) yield curve flattening.

Some of the way key politicians saw the monetary and fiscal interaction issues are reflected in a file note the Governor wrote on 17 December recording meetings with the Minister of Finance and, separately, with the Prime Minister over the previous few days.

The Minister "indicated that she had no difficulty with the New Zealand dollar depreciating if that was what the market felt was appropriate in response to the fiscal package, but she wanted no suggestion that the Government was trying to engineer such a deprecation, or that the Reserve Bank was."

Meanwhile, "the Prime Minister clearly feels that the economy is currently very weak", and he "indicated that he personally favoured the kind of statement we made in reaction to Mike Moore's growth agreement 'despite Ruth's comments at the time'. In other words, he felt that we might be able to say that we would not prevent markets reacting favourably to improved fiscal outcomes. He was not suggesting, or advocating in any way, an activist easing of monetary policy."

The Bank released a statement on the day of the package, worded rather less effusively than the statement associated with the Growth Agreement (but emphasising the consistency of overall message). The Bank explained its thinking in the February 1991 *Monetary Policy Statement* as follows:

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[10] And shifting to the model adopted in all subsequent PTAs, in which deviations of inflation from the target resulting from one-off price shocks were to be handled by publication and analysis in the MPS rather than by renegotiation of the target itself. By this time, Treasury - previously favouring relatively mechanical accountability structures – was talking at the most senior levels about the possibility of much looser open-ended targets. Graeme Scott was heard to wonder whether a formal PTA was needed at all.