IMPROVING MACROECONOMIC STABILITY

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ECONOMIC UPGRADE
MONETARY POLICY

Labour

Authorised by David Parker, Parliament Buildings, Wellington

FOREWORD

Monetary policy is not a topic which is easily accessible. Most people think it must be important because we give to independent Reserve Banks the ability to control their interest rates. Some understand they do this to control inflation.

Others hear from exporters how monetary policy impacts substantially on exports and jobs. Exporters know this has big effects on the quality of jobs in New Zealand, and how much we borrow from the rest of the world when we don't earn enough to pay for our imports and interest.

Specialists know that not all of this falls to the Reserve Bank. They also know that if housing policy fails and there are huge increases in house prices, the Reserve Bank has to react even though they have not caused the problem.

Monetary policy is important and complex, but it was not written by Moses on a stone tablet. It does need to change to better meet current challenges, and that is what this document proposes – changes to make our economy stronger.

We have interest rates higher than our competitors, an overvalued currency, and high external liabilities born of 40 years of external deficit. The changes proposed will help overcome these challenges, without losing the Reserve Bank's inflation anchor and independence.

I have been assisted in the drafting of this paper by many people who have given time and drafting assisting: former Finance Ministers and Associates, former members of the board of the Reserve Bank of New Zealand, economists, industrialists, academics, my parliamentary colleagues, and business leaders from both capital and labour. Thank you all.

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IMPROVING MACROECONOMIC STABILITY

A Review of New Zealand's Monetary Policy Framework

"The crisis has brought home something that should have been recognized before the crisis: managing inflation is not an end in itself but a means to an end. The end is a more stable economy – not just price stability but real stability – and an economy that is growing faster in a sustainable way."[1]

- Joseph Stiglitz

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The paper is divided into the following parts:

1 *Joseph Stiglitz,* In the Wake of the Crisis, edited by Blanchard, Romer, Spence and Stiglitz '*Macroeconomics, Monetary Policy and the Crisis', Pg. 34*

1.0 The new objective of the Reserve Bank – to control inflation in the manner which best assists achieving a positive external balance

1.1 This memorandum proposes changes to New Zealand's monetary policy framework.

1.2 The changes broaden the objectives of the Reserve Bank of New Zealand by amending the Reserve Bank Act to include achieving balance in New Zealand's external position.

1.3 The existing objective of the Reserve Bank of New Zealand is:

"...the primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices."

Monetary policy, like other areas of policy, is never 'finished'. It can and should be reviewed and contested.

1.4 As Harvard monetary policy expert Professor Jeffrey Frankel has said, no single system of monetary policy is right for all countries, nor right for any one country all of the time.

1.5 Current projections and the record of the last two decades show that under current settings a positive external balance is unlikely to be achieved. At -66% of GDP, New Zealand's net international liabilities are high. High interest rates are also entrenched.

1.6 The failure to grow exports and sustain import substitution is one of the reasons per capita GDP and productivity growth in New Zealand have both been disappointing. Underinvestment in the tradable sector has contributed to the concentration of employment in low paid service jobs, with contraction in middle income employment in sectors such as manufacturing.

1.7 The current National government's export objective since 2008 has been to increase exports to 40% of GDP by 2025. Exports were 32% of GDP in 2008. With the best terms of trade for 40 years, exports were 33% of GDP in 2013, and are projected by the Treasury to be 30% of GDP in 2018. It is clear the objective will not be achieved under current settings.

1.8 If New Zealand is to decrease its net international liabilities, and do better in growing per capita incomes (particularly for low and middle deciles), greater priority will need to be given to achieving growth in its foreign exchange earnings or saving sectors.

1.9 To achieve this over-riding objective, a suite of changes in macro and micro economic policy will be required. The New Zealand Labour Party's proposals include improvements to domestic work-based savings and the depth of capital markets; the removal of tax biases which currently encourage capital into the speculative sector at the cost of the productive sector; and tax incentives to improve New Zealand's private sector investment in research, development and plant. This paper addresses changes proposed to monetary policy.

1.10 Exchange rates are a key determinant of profitability and cash flow generation for the tradeable sector, and hence a major risk factor influencing the ability and willingness of market participants to invest. While CPI inflation targeting has helped domestic price stability, exporters note that for them effective price stability cannot be divorced from currency volatility and levels.

1.11 Exporters and import substitutors understand that economics is multi-faceted, and addressing the effect of monetary policy on the exchange rate is but one component of a comprehensive approach to achieve the objective of a balanced external account.

1.12 Because New Zealand's internal market is small, producers of tradeable goods and services are often more reliant upon exports than those based in larger economies. This means that exchange rate risks are concentrated for many New Zealand based exporters c.f. their competitors with larger internal markets.

1.13 Current settings lead to pessimistic projections for the tradeable sector and hence under-investment. Further investment in fixed assets, innovation, and staff often depends upon participants' projections of future exchange rates.

1.14 For three decades, participants earning or saving foreign exchange have experienced governments which have paid insufficient attention to the settings needed to maintain export competitiveness. Their experience has been that the government either didn't care how they fared or believed the infallible hand of markets would achieve equilibrium. Thirty years of history have shown the naïvety of the latter view, with New Zealand's net international liabilities stuck at high levels.

1.15 Investment decisions are forward looking. It is no surprise that faced with a likely unfavourable future export environment to which policy makers would be indifferent, there has been under-investment in exports outside of the perishables from the dominant primary processing sector.

1.16 A country's exchange rate should reflect the strength of its economy. When higher than the fundamentals of the economy justify, exporters and import substitutors and the long term strength of the economy are all undermined.

1.17 The New Zealand Labour Party has concluded that the current trend is clear and undesirable, and that monetary policy is partially responsible. It has concluded that a broader focus for the central bank in support of macroeconomic stability would assist.

1.18 Global and domestic economic developments over recent years suggest that monetary policy's almost exclusive focus on low inflation, while probably necessary to bring high inflation under control in the 1980s, has become too narrow for today's challenges.

1.19 The experience of the Global Financial Crisis and the period leading up to it has demonstrated the degree of general macroeconomic instability that can flow from high credit growth, inflated asset markets and trade imbalances.

1.20 It is now widely accepted that central banks will have to assume wider macroeconomic responsibility, with particular focus on emerging imbalances – including in asset markets - that pose threats to medium-term macroeconomic stability.

1.21 In the case of New Zealand, the monetary authority's focus should also include the consequences of persistent external deficits.

1.22 Through the pursuit of low inflation with little regard to other variables, monetary policy has contributed to the persistent overvaluation of the NZ dollar. The small size of the NZ dollar market has at times generated large responses to international interest rate differentials.

1.23 The cumulative costs associated with a loss of international competitiveness and the narrowing of the tradeable sector have been substantial.

1.24 Accordingly this paper proposes a change to the objective of monetary policy, and the deployment of additional tools to assist in meeting the broadened objective.

1.25 Critics of proposals to modify monetary policy, wedded to the status quo, often default to the assertion that changes imply a desire to intervene directly in the foreign exchange market and a willingness to tolerate higher inflation. Contrary to this straw man implication, there are a number of options that should be developed, ranked and prepared for activation. Using the mechanism described in parts 3 to 5, the Reserve Bank does not lose control of its inflation target.

1.26 As the quote from Joseph Stiglitz included at the start of this paper says, "... managing inflation is not an end in itself but a means to an end. The end is a more stable economy – not just price stability but real stability – and an economy that is growing faster in a sustainable way."

1.27 In assuming wider responsibility for macroeconomic stability, the Reserve Bank would have to explicitly consider, and make public, the trade-offs associated with its policy decisions. In doing so, the Bank would improve its contribution to the overarching economic policy goal of enhancing economic welfare.

1.28 It is accordingly proposed that the objective of the Reserve Bank be updated and broadened as follows:

The primary function of the Bank with respect to monetary policy is to enhance New Zealand's economic welfare through maintaining stability in the general level of prices in a manner which best assists in achieving a positive external balance over the economic cycle, thereby having the most favourable impact on the stability of economic growth and the level of employment.

2.0 The Revised Policy Targets Agreement

2.1 The New Zealand Labour Party remains committed to an independent full service Reserve Bank, which it introduced in 1989.

2.2 With the introduction of monetary policy directed to inflation targeting, following a long period of high inflation, New Zealand led the world in the 1990s. This important history and the performance of the New Zealand economy since are discussed in sections 7 to 11 below.

2.2 The new objective would be operationalised through a revised policy targets agreement between the Governor of the Reserve Bank and the Minister of Finance.

2.3 The Reserve Bank would retain its independence, and its obligation to achieve its inflation objective.

2.4 The new Policy Targets Agreement (PTA) would include the existing inflation target, which would remain unchanged.

2.5 The external balance objective in the PTA would state the government's objective for the external balance. This would include a both an objective range for the medium term, and a longer term trend objective towards a positive external balance. The objectives set by government will be influenced by projected long term growth rates and the desired level of net international liabilities.

2.6 The achievement of a positive external balance will be a multi-year process and will involve a correction of the exchange rate. The adjustment may be less prolonged than current economic models would suggest. A macroeconomic strategy credibly focused on a more competitive exchange rate and the external balance along with a change in the mindset of policy-makers will encourage higher rates of investment in the tradeable sector than experienced under the current policy regime.

2.7 The agreement would invite advice from the Bank as to what mix of instruments would best achieve the new broadened objective. It is quite properly beyond the scope of the Reserve Bank to implement some of the measures which could be used.

2.8 It will sometimes be appropriate for the government of the day to reject the use of other instruments, because the multiple objectives which governments have to balance are broader than monetary policy outcomes.

2.09 Where alternatives to an increase in the overnight cash rate are rejected, the Reserve Bank would instead use the OCR, never losing control of its inflation target.

2.10 It is intended that this process will expose the important tradeoffs involved. This will aid in public and political understanding and lead to better decisions for the betterment of the tradeable sector and New Zealand's external position.

2.11 These instruments are discussed in more detail below:

3.0 How existing and new tools would be implemented

3.1 This paper identifies a number of initiatives that could be implemented in pursuit of the Reserve Bank's broadened mandate. These tools could make investing in foreign exchange generating activities more attractive, or take pressure off the currency, or reduce the imbalances which discourage savings and contribute to inflationary pressures.

3.2 This document does not purport to decide which options the Reserve Bank should implement at any particular time.

3.3 Three categories of tool are identified below:

- Existing tools already in the Reserve Bank tool kit, which may be applied differently because of the broadened objective.
- The new tool, which the Reserve Bank could formally recommend to the government for use instead of a change to the OCR ("New Tool").
- Other measures, which the Governor could recommend that the government consider. These would not be substitutes for current OCR decisions, but would be identified as important topics for the government to address.

3.4 Arguments can be put for and against each tool, just as arguments can be mounted for and against use of the OCR.

3.5 With a wider responsibility for macroeconomic stability, the Reserve Bank would explicitly consider the trade-offs associated with its policy decisions and recommendations.

3.6 Whether the New Tool discussed below is in fact deployed would be a decision that would be taken by the government on the recommendation of the Reserve Bank, and would reduce reliance by the Bank on its interest rate lever.

3.7 The New Tool would only be able to be used by the government when recommended by the Governor for monetary policy reasons, rather than as a political measure.

3.8 Parliament would be unlikely to delegate to the Reserve Bank the power to use (rather than recommend) the New Tool, although the pros and cons of some limited delegation within a defined range will be openly considered.

3.9 The analysis of which alternative measures might be used to take pressure off the interest rate (the OCR), and what trade-offs are involved, would be included by the Reserve Bank in advice to the government each time it is due to makes its determination of the overnight cash rate.

3.10 The Treasury would also provide its own advice to the government, independently of the Reserve Bank.

3.11 If the government chose not to use the New Tool recommended by the Reserve Bank, the Reserve Bank would use its interest rate lever, or its other existing tools.

3.12 The Reserve Bank thus maintains control and responsibility for achieving its inflation target.

3.13 The policy work on other measures, which could be used to assist the Reserve Bank to achieve the broader mandate, would be carried out by the Treasury in consultation with the Reserve Bank.

4.0 Existing tools which may be applied differently

4.1 The existing tools of the Reserve Bank include adjusting the interest rate, foreign exchange purchases, and so-called macro-prudential tools such as capital ratios, and loan to valuation restrictions.

4.2 Broadening the objective of the Reserve Bank to include the external balance objective will require the Reserve Bank to consider whether the broadened objective can be advanced through a varied use of the Bank's existing tools.

4.3 Macro-prudential ratios were used sparingly prior to the GFC. While their use has expanded since the GFC, they are still notionally deployed for prudential purposes, rather than monetary policy objectives.

4.4 For example, changes to capital requirements set by the Reserve Bank for different classes of lending are currently motivated by financial stability considerations. Under a broadened objective, the Bank may deploy these to limit runaway credit growth and reduce currency pressures even when prudential standards are already met, so as to achieve its broader objective. The Bank would provide advice as to the knock on effects on interest rates and capital availability.

5.0 New Tool to be investigated to reduce reliance on higher interest rates – Varying the Contribution Rate for Work based savings

5.1 In 2006, under the previous government, Treasury and the Reserve Bank produced a report entitled 'Supplementary Stabilisation Instruments', which examined other policy measures that could be used to complement the OCR and avoid some of its negative effects.

5.2 Several of those instruments have since been partially adopted by the Reserve Bank or the current government: tighter enforcement of rules on property traders, limiting claims for property losses being claimed against other income (applied only to holiday homes at present), loan to valuation ratios (applied, in effect, mainly to first home buyers) and counter-cyclical bank capital requirements (Basel III).

5.3 Labour has previously announced its intention to go further by ring-fencing losses on all investment properties, by introducing a capital gains tax on gains realised upon sale of investment properties, and by improving housing supply through our KiwiBuild policy.

5.4 Further tools are desirable to assist the Reserve Bank. Therefore, Labour will ask the Reserve Bank and Treasury to assess in detail the new tool discussed in this section, and to report to the Government on how it could best be implemented.

5.5 Any new adjustable tool will have to help to deliver price stability while assisting to reduce our external imbalance. It must be fair and equitable for New Zealanders.

5.6 It is desirable that changes to the instruments used to give effect to monetary policy are durable, reliable, and free from political gaming.

This is important to maintain confidence in our monetary policy system. The current National and previous Labour Government have endeavoured to achieve a consensus. Labour will continue with that approach, which requires open consideration of proposals rather than their pre-emptory dismissal.

5.7 There will be critics and supporters of these proposals. The process described above will enable those views to be put in writing to the Reserve Bank and Treasury before any final recommendation is made to the government as to whether or how a variable KiwiSaver contribution rate should be activated.

5.8 Although for many years the Reserve Bank downplayed the relationship between differences in New Zealand and overseas interest rates and the carry trade, in more recent years this has been acknowledged.

5.9 The differential between domestic and overseas interest rates is a driver of capital flows, and from time to time has been a significant determinant of the exchange rate. Capital flows, credit growth, and demand for currency have been driven by the profits to be made by borrowing at lower rates overseas for lending in New Zealand.

5.10 Reducing the reliance on the OCR, thereby reducing the differential between New Zealand and overseas interest rates, will alleviate the carry trade consequence of the differential between NZ and overseas interest rates.

5.11 Varying the employee contribution rate for work based savings. An alternative which would take pressure off the OCR mechanism would be to increase or lower savings rates, rather than interest rates, to reduce or boost local consumption.

5.12 The New Zealand Labour Party is proposing that the existing KiwiSaver scheme become a universal work place savings scheme. This would be achieved by making KiwiSaver compulsory, with exceptions limited to those which apply to the Australian scheme.

5.13 As additional people are enrolled in KiwiSaver, and as contributions are increased from the current 6% (3% from the employee, and 3% from the employer) towards the intended total of 9% of earnings, consumption pressures will be lower than they would otherwise be.

5.14 The policy targets agreement would set out the government's intentions in respect of savings during the transitional period. During this transitional period, the Reserve Bank should be able to manage inflationary pressures with lower interest rates than would otherwise be necessary.

5.15 The PTA could request that the Reserve Bank use this once in a life time opportunity to attempt to get underlying (as opposed to cyclical) New Zealand interest rates back to the levels charged in other countries. The structurally higher interest rates paid in New Zealand are discussed further below.

5.16 Once a universal work based savings scheme is in place, consumption could be abated by increasing the employee contribution to their savings, rather than increasing interest rates.

5.17 Additional savings delay consumption rather than transfer wealth from interest payers to lenders. Higher interest payments are lost to the payer forever. Higher savings belong to the saver. In New Zealand's case a large portion of the higher interest is paid overseas and lost to our economy.

5.18 Conversely, savings rates could be lowered when the Reserve Bank wished to stimulate rather than decrease consumption.

5.19 The policy targets agreement would state whether or not it was the government's expectation that over the economic cycle Reserve Bank variations to the compulsory savings rate would be neutral. The PTA could limit the range in which the variable savings rate could move.

5.20 Using changes in savings rates as an alternative to changes in the overnight cash rate would mitigate the currency effects of higher or lower interest rates, and reduce overseas transfers on the proportion higher interest payments which currently go to overseas lenders.

5.21 Distributional and hardship effects for the lower paid would need to be considered, but could be accommodated in the detail of how the variable rate was designed (for example by excluding lower income earners, whose savings are lower).

6.0 Other measures which could be recommended for consideration by Government – Monetary policy needs friends

6.1 A comprehensive and consistent programme to address imbalances would, as has been stated earlier, be wider than the measures which the Reserve Bank can influence.

6.2 Addressing the country's structural imbalance requires a rise in domestic savings both to replace foreign liabilities and to fund increased investment in the internationally tradeable sectors.

6.3 Other actions can be taken to address this concern, including those suggested below.

6.4 Some are clearly outside the ambit of the Reserve Bank, but should also be considered by the government. As the former Governor of the Reserve Bank, Alan Bollard, said, "monetary policy needs friends". Examples of these follow.

6.5 Remove the tax distortions which hinder local businesses

Another step which could be considered would be to move New Zealand's taxation regime away from favouring foreign capital over domestic. Current settings have damaged New Zealand's head-quartered corporate sector.

6.6 New Zealand cash flows have been of more value to foreign owners than New Zealand tax residents.

6.7 This has been reinforced by low thin capitalisation rates, transfer payments for intellectual property and head office services, equity structured as debt, and parent company loans at inflated interest rates.

6.8 The failure to enforce taxation on overseas corporates competing in New Zealand has meant that NZ resident competitors have paid higher effective rates of tax to their competitive detriment.

6.9 Little wonder that when a New Zealand corporate falters it is often bought by a foreigner.

6.10 Stabilising the housing market through KiwiBuild

House prices are the major driver of inflation in New Zealand, both directly and through the so-called ‘wealth effect’, which encourages households to realise gains in wealth through rising house prices by taking on higher debt for consumption.

6.11 If house prices were stable, there would be less call on the Reserve Bank to maintain relatively high interest rates, which would, in turn, allow the currency to return to a fair level.

6.12 Just as importantly, stable house prices would make it more affordable for families to buy a home and would stem the rapid decline in homeownership rates.

6.13 The property market is marked by under-supply of affordably priced homes with property developers preferring higher-profit, more expensive homes. This, along with the tax advantages for housing investment (see below), has driven the price of houses higher at unsustainable rates.

6.14 Labour’s KiwiBuild programme is designed to build 100,000 affordable homes over 10 years and sell them to families. This will help to stabilise the market, and significantly reduce the major driver of inflation in our economy.

6.15 Taxation of Capital Gains

Another step to encourage NZ savings, and investment in the export and import substituting real economy, would be to remove the tax bias which currently favours investment in land based investments.

6.16 This tax bias is unusual in western countries and contributes to underinvestment in the productive economy, and savings.

6.17 The tax advantages drive asset prices, and demand for mortgage borrowing, to higher levels than would otherwise be sustained. This increases demand for imported borrowings, which puts pressure on the exchange rate.

6.18 This distortion in the tax system also pushes up house and other property prices beyond the reach of many, while enabling wealthier New Zealanders to pay lower rates of tax on their economic income.

6.19 Reducing non-tradable inflation through market reform

The tradeable sector in New Zealand is in deflation and is the major victim of OCR rises, while the sources of inflation are in the non-tradable sector.

6.20 Stabilising the housing market through KiwiBuild and Capital Gains Tax have already been discussed as means of reducing non-tradable inflation. Fixing broken markets is another.

6.21 After housing, electricity and insurance were the largest sources of inflation in the past year (excepting the excise increases on tobacco products).

6.22 Electricity prices are rising rapidly, despite low and stable production costs for most of our electricity, as a result of the market rules set up by the 'Bradford reforms'.

6.23 Labour's NZ Power plan will bring down electricity costs. It will break the market power of the generator/retailer oligopoly, stop over-charging for our lost-cost hydro power, and reduce power costs to businesses.

6.24 Counter cyclical easing back on inwards migration or work permits

The rate of net migration has been seen by a Reserve Bank study to be a driver of housing demand which has impacted on house prices, consumer confidence, in turn influencing consumption and general price inflation.[2]

6.25 Net migration into New Zealand has varied from negative 2,000 to 40,000 people each year.

6.26 Immigration tends to be pro-cyclical, with higher net inwards migration rates coinciding with strong local economic conditions.

6.27 There may be a case for varying inward migration and/or work permits in a counter cyclical manner. This would require consideration of a range of factors, including the lag time between approval and arrival, the wage effects of inward migration at times of supply constraints, and the need to meet skill shortages.

7.0 Why the Reserve Bank Act 1989 established an independent Reserve Bank charged with controlling inflation

7.1 From World War II until the 1970s the monetary policy settings agreed at Bretton Woods prevailed in New Zealand. Settings included capital movement controls and exchange rate stability. The decades following WWII were prosperous, the wealth of New Zealanders grew, and inequality was low.

7.2 By the late 1970s, a global energy crisis and stagflation were challenging many governments. An increasingly regulated response from the New Zealand government followed. Large subsidies were paid to primary produce exporters, and tariff and import licensing restrictions protected the import substitution sector. The ambit of regulation was wide. Carless days were regulated. The government embarked on a number of large commercial "Think Big" ventures.

2 *Michael Reddell, 'Housing: more than a symptom but less than a cause',* Reserve Bank of New Zealand 23 June 2011, http://www.treasury.govt.nz/downloads/pdfs/mi-jarrett-comm.pdf

7.3 New Zealanders went to the polls in 1981 with inflation running at over 15 per cent and low growth. The government was re-elected by a narrow margin and continued with a highly regulated economy. By 1983, many of the then National government's Think Big projects had suffered delays and cost overruns. Double-digit inflation had been running for a decade. Wages had failed to keep pace. The government had responded with an economy wide price and wage freeze. It failed. The economy stalled and the government's financial position was in free fall.

7.4 By the time the government changed in 1984, reforms were needed. The government deficit had ballooned, inflation was high, and there was a run on New Zealand's currency. The incoming Labour government implemented a suite of changes. The price freeze was lifted. Import licensing, tariffs, farm subsidies, exchange movement controls were removed, and the dollar was floated.

7.5 The cyclical behavioural response to anticipated inflation was hard to break. Interest rates for home loans hit 20 per cent by the mid-1980s.

7.6 The efforts of the Reserve Bank to rein in inflation were formalised in the late 1980s. By then New Zealand had been suffering from high and erratic inflation averaging between 10 and 15 per cent for close to two decades.

7.7 Under the Reserve Bank of New Zealand Act 1989, the Bank was given operational independence by the then Labour government to manage monetary policy to control inflation.

7.8 The Act states that"...the primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices. "

7.9 The operational details of the Bank's inflation target are set out in a separate agreement between the Governor and the Minister of Finance, the PTA.

7.10 The PTA cannot override the provisions of the Act. The PTA makes mention of other economic variables near the end of clause 3.b under the heading "Policy Implementation". It states "in pursuing its price stability objective, the Bank shall ..... seek to avoid unnecessary instability in output, interest rates and the exchange rate". In practice the bank gives primacy to inflation targeting, as the Act directs.

7.11 The pursuit of lower inflation was not without cost, but by the early 1990s low inflation had been achieved. As the Reserve Bank observes, "it has since become a well-entrenched feature of the economic landscape". [3]

7.12 A high or volatile exchange rate is not the only economic setting which hurts the economy – inflation matters. High inflation, especially in the absence of any capital gains tax, encourages speculative investments in land and buildings to the detriment of investment flows into productive capital equipment. The high interest rates associated with high inflation also increase the cash cost of investing in capital equipment needed to improve productivity and maintain export competitiveness.

3 *Reserve Bank of New Zealand, 'The Reserve Bank and New Zealand's economic History', 2007, Pg. 23,* http://www.rbnz.govt.nz/research_and_publications/fact_sheets_and_guides/3072801.pdf

7.13 The crippling effect of high and volatile inflation is uncontested. High inflation, at best, has only transitory beneficial effects on economic growth, resulting from short-term expectation errors by economic decision-makers. No positive growth/inflation trade-off exists in the long run. On the contrary, uncertainty about the inflation outlook adversely affects decision-making by households and businesses, and lowers the potential growth rate of the economy over time. High inflation is hardest on those who lack the means to buy and leverage assets which inflate in value.

7.14 It should also be acknowledged that the international trend over this period was for lower inflation anyway, and some inflationary pressures would have abated even without the Reserve Bank Act. The spike in imported energy costs passed. The effects of the communication and information technology revolution included major advances in automation. These technology changes combined with lower labour costs in rapidly industrialising emerging markets markedly deflated the price of most consumer goods.

7.15 So while the success of the Reserve Bank Act 1989 is reasonably clear - low and stable inflation - we should not be blind to the limits and side effects of current monetary policy.

7.16 Other countries achieved control of inflation without, as is the case in New Zealand, a prolonged current account deficit or interest rates higher than international norms.

8.0 The policy objectives of other central banks

8.1 Several of the major central banks have a similarly narrow definition of their primary role.

8.2 The Treaty of the European Union states that "...the primary objective of the European System of Central Banks [ESCB) is to maintain price stability." References to other objectives are explicitly subordinated to achieving the main goal of monetary policy. The Treaty states that "Without prejudice to this objective the ESCB shall support general economic policies in the Community with the objective of contributing to achieving the Community's aims".

8.3 The Bank of England's statutory framework is similar, with other economic objectives subordinated to the low inflation goal: "The Bank's monetary policy objective is to deliver price stability (low inflation) and, subject to that, support the Government's economic objectives including those for growth and employment".

8.4 The Swiss National Bank is an independent central bank, with the mandate to conduct monetary policy in the interests of the country as a whole. The mandate requires the SNB to ensure price stability and, in so doing, to take due account of economic developments. The SNB is thus charged with resolving in the best general interests any conflicts arising between the objective of price stability and business cycle considerations, giving priority to price stability.

8.5 In their 12 December 2013 decision, the SNB decided to maintain its minimum exchange rate of CHF1.20 per euro. According to the Bank, "The Swiss franc is still high. The SNB stands ready to enforce the minimum exchange rate, if necessary, by buying foreign currency in unlimited quantities, and to take further measures as required."

8.6 Other major central banks' statutes include more explicit references to a multi-target focus of monetary policy, including economic prosperity, growth, employment, and long-term interest rates.

8.7 The United States Federal Reserve's statutory mandate from Congress is " ... to promote maximum employment, stable prices, and moderate long-term interest rates".

8.8 The Bank of Canada Act obliges the Bank " ... to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada."

8.10 The Reserve Bank of Australia Act states that "In determining monetary policy, the Bank has a duty to maintain price stability, full employment, and the economic prosperity and welfare of the Australian people."

8.11 Although these stated objectives do not explicitly mention the goal of achieving external balance, or maintaining export competitiveness, that objective is inherent in other aspects of their mandate.

8.12 Where multiple targets are mentioned, the practice in these countries up until the Global Financial Crisis was generally to treat price stability as the dominant goal.

8.13 However, since the GFC, the degree of interest rate reductions and quantitative easing in some countries clearly indicates that the respective central banks have been willing to risk a rise in medium-term inflation in the interest of stimulating economic activity over the near term, regardless of whether they formally operate with a multiple objectives framework (Federal Reserve) or with a primary price stability goal (Bank of England). The Swiss have actively protected their currency from appreciating to the detriment of their tradeable sector.

8.14 Other countries, including a number of successful Asian economies, have placed more emphasis on maintaining a stable and competitive exchange rate.

8.15 For example, the People's Bank of China has the following objective: The objective of the monetary policy is to maintain the stability of the value of the currency and thereby promote economic growth. The PBC is not fully independent of the State Council. The monetary policy instruments applied by the PBC include reserve ratios, the central bank base interest rate, as well as other policy instruments specified by the State Council. The State Council objectives include inflation, employment and the external balance. The Chinese government remains committed to a strong current account surplus.

9.0 Monetary Policy since the Reserve Bank Act 1989

9.1 For the last twenty-five years, monetary policy in New Zealand has almost exclusively focussed on the pursuit of short- to medium-term domestic price stability.

9.2 Operating with a narrow mandate, the Reserve Bank does not have to give weight to the wider and longer-term macroeconomic implications of its policy decisions (e.g. contributing to a structural overvaluation of the exchange rate and the consequences for New Zealand's external balance).

9.3 In the event of a contest between achieving the inflation target and other economic outcomes, inflation targeting invariably prevails.

9.4 Moreover, the Bank's limited monetary policy tools have made it difficult to address some risks to medium term price stability (e.g. overvaluation of asset markets) in an efficient manner.

9.5 A consequence of the dominance achieved by "inflation targeting" in New Zealand, is that monetary policy has been written down to a focus on setting the overnight risk free interest rate (and very occasionally, and more contentiously, dabbling in the FX market).

9.6 Little attention has been given to asset price inflation until very recently, and even now the use of macroprudential tools is weighted towards concerns about stability of the financial sector rather than the health of the economy or social equity.

9.7 The dominance of inflation targeting has been encouraged both by the legislated primary function, to control inflation, and by the somewhat unusual provision in section 10 of the Act which directs the Bank to promote the "economic objective" of monetary policy. That economic objective is legislated to be (except as suspended by regulation pursuant to section 12, which has never been done), that primary function i.e. to control inflation.

9.8 In other words, the Reserve Bank not only must give primacy to the pursuit of inflation targeting, but is instructed to promote the idea that inflation targeting is the correct thing to do.

9.9 Added to this, for more than two decades there was a broad political consensus that current settings were fit for purpose and required no substantial change.

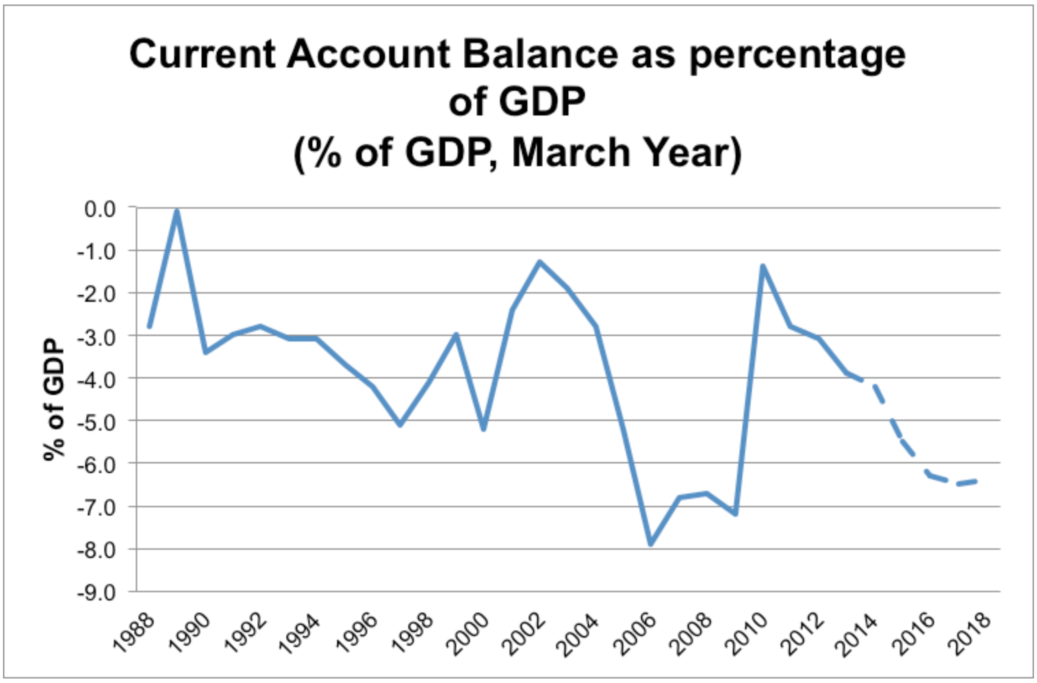
9.10 In the face of this political consensus, and the devolution of the implementation of inflation control to the Reserve Bank, the policy capability and oversight of monetary policy in the Treasury and wider government atrophied.

9.11 The dominance of the current settings has hindered consideration of additional policy instruments that might have assisted equal achievement on the inflation front with a more favourable impact on the external balance.

9.12 The experiences of the Global Financial Crisis, an inflated domestic housing market, as well as New Zealand's long term structural external imbalances, suggest that a broader macro policy focus of the monetary authority - complemented by the availability of additional policy tools – would be beneficial for the long-run macroeconomic stability and growth of the New Zealand economy.

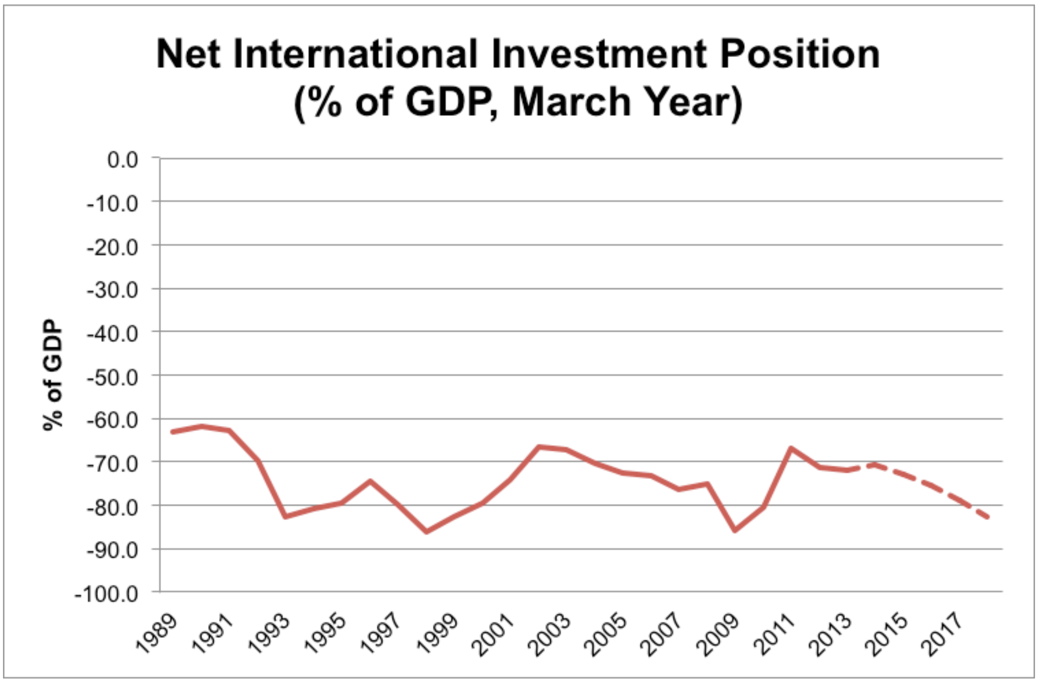
10.0 The long term problem of New Zealand's external balance

10.1 For forty years New Zealand has run a current account deficit, averaging around 4% of GDP.



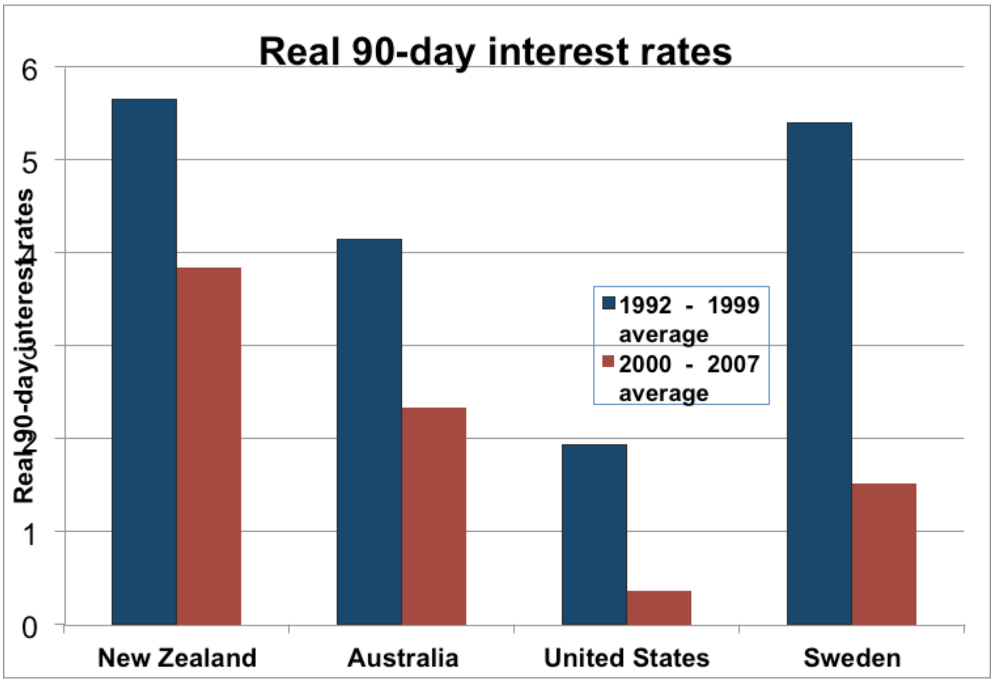
Source: Statistics NZ & Treasury (forecast)

10.2 To cover this cash outflow, New Zealanders have sold assets to, or borrowed from, foreigners. As a result New Zealand's net foreign liabilities are around 75% of GDP, a very high ratio by international standards.



Source: Statistics NZ & Treasury (forecast)

10.3 NZ interest rates are now consistently higher than in competitor countries. In addition to the increasing cost of debt finance and servicing costs paid to overseas lenders, overseas based business owners can borrow at lower rates than competing New Zealand owners sourcing their funds in New Zealand.



10.4 Currently, with the best terms of trade in 40 years, New Zealand's current account deficit is still over 3% of GDP. By comparison, when New Zealand's terms of trade were last this good - in the early 1970s – New Zealand ran a current account surplus.

10.5 There is a widely held view that New Zealand's currency is overvalued most of the time.

10.6 The IMF recently estimated that the NZ dollar is overvalued by up to 15%.[4]

10.7 Based on OECD figures, HSBC says the NZ currency is sixth most overvalued in the developed world.[5]

10.8 In November 2013 the Reserve Bank of New Zealand said: "The Reserve Bank believes that, from a long-term perspective, the exchange rate is overvalued".[6]

10.9 The current Governor Graeme Wheeler earlier said in February 2013: "In mid-2012 the IMF suggested the currency was over-valued by 10-20 percent and the OECD also considers the exchange rate over-valued. We believe the exchange rate is significantly over-valued relative to what would be sustainable long term in the absence of sizeable increases in the terms of trade and productivity."[7]

10.10 The Bank of International Settlements says the NZ Dollar is the tenth most traded currency in the world. The NZ dollar makes up 2% of foreign exchange transactions, up from 0.2% in 1998 when it was 17th.[8]

10.11 The only substantial relief from the pattern of deterioration in our foreign indebtedness in recent years was the result of the reinsurance receipts following the devastating earthquakes in Canterbury. This was the second largest insurance event ever, world-wide. The reinsurance receipts totalled over 10% of GDP. They were received at the tail end of the GFC which had also suppressed New Zealand consumption, and were a substantial contributor to the one-off decrease in net international liabilities shown above.

10.12 There are a number of problems arising from high net foreign liabilities.

10.13 They can reach a tipping point, where foreigners' willingness to lend collapses and an Iceland or Greece scenario results, with a sudden shock.

10.14 They lead to higher effective interest rates, in part to compensate the overseas lenders for the risk that the currency may drop significantly. This has become a major component of New Zealand interest rates, with the cost of covering that forward exchange risk factored into interest rates.

10.15 A more insidious consequence is that the on-going return paid to overseas owners of our net foreign liabilities diminishes the

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4 *The New Zealand Herald, 'IMF says kiwi dollar overvalued', April 1 2014,* http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11229779
5 *Sydney Morning Herald, 'Dollar the most overvalued currency', February 15 2013,* http://www.smh.com.au/business/markets/dollar-the-most-overvalued-currency-20130215-2eho2.html
6 *Reserve Bank of New Zealand, 'Understanding the New Zealand exchange rate', November 22 2013,* http://www.rbnz.govt.nz/news/2013/5540551.html
7 *Reserve Bank of New Zealand, 'Manufacturing decline not just a dollar story', February 20 2013,* http://www.rbnz.govt.nz/research_and_publications/speeches/2013/5150125.html
8 *Otago Daily Times, 'Kiwi likely to retain popularity', January 3 2014,* http://www.odt.co.nz/news/business/287096/kiwi-likely-retain-popularity

proportion of our GDP that accrues to New Zealanders. Even with historically low interest rates, between 5 and 6% of our annual GDP is now for the benefit of foreigners. The earnings of our four largest Australian-owned Banks are by themselves more than New Zealanders' share of the earnings of all NZX listed New Zealand headquartered stocks.

10.16 Another consequence is the home-country bias of overseas owners. Unsurprisingly, the higher paid management jobs, research and development spending, and leading edge technology are concentrated in the overseas locale of the owner, rather than New Zealand.

10.17 The tradeable export sector in New Zealand already faces challenges arising from being in a small economy. With small internal markets to sell to, they face the additional risks inherent in exporting earlier than competitors from larger countries. Exports often account for a greater percentage of total sales when internal markets are small. This means that the consequences of exchange rate risks are concentrated.

10.18 A repeated complaint from the tradeable export sector is that the unwillingness of government to address this reality with an appropriate policy response to avoid an uncompetitive exchange rate is a significant cause of underinvestment in the tradeable sector. They say that the effect of current monetary policy is to subvert the interests of the tradeable sector.

10.19 In their view government denies responsibility, saying such matters are delegated to the Reserve Bank, while under current settings the Reserve Bank says their legislated mandate is to give primacy to the inflation target.

10.20 Improving New Zealand's external position through growth in exports and import substitution requires an explicit, forceful and unambiguous statement by successive governments that this is an over-riding economic objective for New Zealand, and the reshaped macro and micro economic policies are needed to achieve it.

Conclusion

This proposal is part of the across-government approach proposed by the New Zealand Labour Party to address New Zealand's external position, build the net wealth of the country, and improve the job opportunities and incomes of those who work here.

Appendix:

IMF: Should Monetary Policy Be Concerned with External Stability?[9]

The crisis has once again highlighted the dangers associated with the ebb and flow of international capital, and with cross-border financial linkages more broadly. Problems arose not just in small open economies, but also in large advanced economies with deep financial systems (for instance, dollar-liquidity shortages disrupted European interbank markets). This has rekindled long-standing questions on what role monetary policy should play with respect to the external sector and about the benefits from international monetary policy cooperation.

Capital-flow and exchange-rate volatility can adversely affect macroeconomic stability through both real- and financial-sector channels, especially in small open economies. When the exchange rate strengthens on the back of strong inflows, firms in the tradable sector may become uncompetitive. This may lead to a resource reallocation that may be costly to undo, should the appreciation turn out to be temporary. Strong inflows can also fuel domestic credit booms and, when they induce greater use of foreign-denominated liabilities, may lead to balance sheet structures that are vulnerable to reversals (Caballero and Lorenzoni, 2009; Caballero and Krishnamurthy, 2003; and Korinek, 2010). Further, large foreign-exchange liabilities can limit the central bank's ability to act as the lender of last resort.

These problems have rekindled the debate on "capital flow management tools" (see for instance, Ostry and others, 2010, 2011, and 2012); and have led the IMF to issue a revised institutional view on the management and liberalization of capital flows (IMF, 2010, 2011a and b, and 2012a and b). However, these measures may not be effective enough, even in combination with macroprudential policy, and, perhaps even more than in the case of financial stability, monetary policy may have to help (Blanchard and others, 2013).

That said, except under unrealistic conditions, a monetary stance aimed at stabilizing domestic inflation will not at the same time guarantee external stability. Then, a new objective—such as managing the exchange rate in the face of volatile capital flows—means either a new instrument or accepting a trade-off between the new external target and the traditional domestic objective.

In economies where financial frictions make foreign and domestic assets relatively imperfect substitutes, central banks can use a mix of interest rate policy and sterilized exchange intervention to target both inflation and exchange rate stability (exploiting the portfolio rebalancing channel (see Disyatat and Galati, 2005, for a survey; see also Ostry and others, 2012, and Benes and others, 2013). Sterilized intervention is less likely to be effective in countries with highly integrated financial systems (such as small open advanced economies) and very deep asset markets (where intervention would need to take place on a massive scale in order to have non-negligible effects on the relative supply of financial assets).

Foreign exchange (FX) intervention can, however, also affect the exchange rate through a signaling channel that changes market expectations about future fundamentals, including the stance of monetary policy. Unlike the portfolio rebalancing channel, it is not clear whether this channel would be stronger in emerging market or advanced economies (in principle, it should be weaker among inflation targeters, where expectations about the policy rate are primarily driven by the inflation objective).

The successful Swiss experience with large-scale intervention may be read in this light. On September 6, 2011, the Swiss National Bank announced that it was "prepared to buy foreign currency in unlimited quantities" (Swiss National Bank Annual Report, 2011, p. 38) to keep the franc-euro exchange rate from falling below SF1.20 per euro. Since then, the Swiss National Bank has successfully maintained its exchange-rate floor against the euro, often through heavy nonsterilized purchases of foreign exchange (Swiss National Bank Annual Report, 2012, p. 34).

9 *IMF,* Monetary Policy in the New Normal, *April 2014, pg. 9-11, - emphasis added* http://www.imf.org/external/pubs/ft/sdn/2014/sdn1403.pdf

As for desirability, intervention should typically not aim to resist trend appreciations driven by changes in fundamentals. Rather, it would aim at smoothing temporary exchange-rate fluctuations. Obviously, one operational challenge is to establish whether capital-flow pressures are temporary or permanent. In addition, there is a gray area when it comes to dealing with possibly long-lasting exchange rate fluctuations, such as those associated with monetary policy cycles in reserve currency countries.

Matters are complicated further by the inherent asymmetry in FX interventions. As capital flows in, and setting the costs of sterilization aside, FX intervention can be unlimited, but as capital flows out, reserves are finite. Even more importantly, heavy use of FX intervention may increase a country's vulnerability to exchange rate movements, if expectations of intervention encourage larger unhedged private sector foreign exchange positions.

More granular advice requires further work. The effectiveness of capital flow management measures (CFMs) and foreign-exchange interventions has to be better understood, also in light of specific country characteristics. Moreover, we do not yet have a solid handle on the complementarities and substitutability of FX interventions, CFMs, and macroprudential policy.

The negative side effects (including from a multilateral standpoint) of each policy response have to be better understood. A careful study of the most recent episodes of interventions and CFMs in light of large capital inflows and outflows may shed further light on these complex questions.

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