

## **Monetary policy in New Zealand**

by Keith Rankin, 22 February 2007

Monetary policy in New Zealand is the classic modern example of the "Emperor with No Clothes" story. The current use of the Official Cash Rate (OCR) as a means to soften the residential housing market can be classed as the misuse of a blunt instrument.

Do we really believe that a small increase in interest rates can cause any meaningful decrease in consumer spending or in the uptake of housing mortgages? And is our current annual inflation rate really so bad that the Reserve bank should contemplate taxing new mortgages as an alternative means of slaying this perennial dragon?

The argument about raising interest rates to combat inflation goes like this:

- Inflation (2.6% current annual rate) is New Zealand's number one economic problem.
- The presence of inflation in excess of 2.5% indicates that current rates of economic growth are unsustainable.
- Inflation is caused by excessive consumer and business spending, including excessive spending on home ownership.
- Increased interest rates will reduce these categories of spending, especially business "investment" spending.
- Economic growth (currently only 1.4%) will slow with reduced business and consumer spending.
- With reduced economic growth, unemployment will increase, and wages will increase more slowly or not at all.
- Businesses will offer goods and services for sale at lower prices than they otherwise would, given that wage costs are reduced and that consumers have downsized their budgets.
- Annual inflation falls below two percent.

Another way of summarising this process is to say that "disinflationary" monetary policy, when it does work, offers a lot of pain for miniscule gain. More often than not it does not work. Commonly, monetary policy simply gives us pain for our pain. In particular, it creates huge imbalances between our internationally competitive tradeable sector and our domestic-only non-tradeable sector.

In a disinflationary policy environment, the exchange rate increases because financial investors (including the foreign parent banks of our own banks) favour New Zealand dollar investments which give higher returns than do investments elsewhere. The money inflow that causes the exchange rate to appreciate has few places to go other than into the residential housing market. Parts of the domestic economy boom, while the tradeable sector busts.

We must ask ourselves if inflation really is such a great problem. Many would argue that the huge current account deficits, low wages, low productivity, high taxes, environmental issues, and the entrenchment of an underclass are much more important.

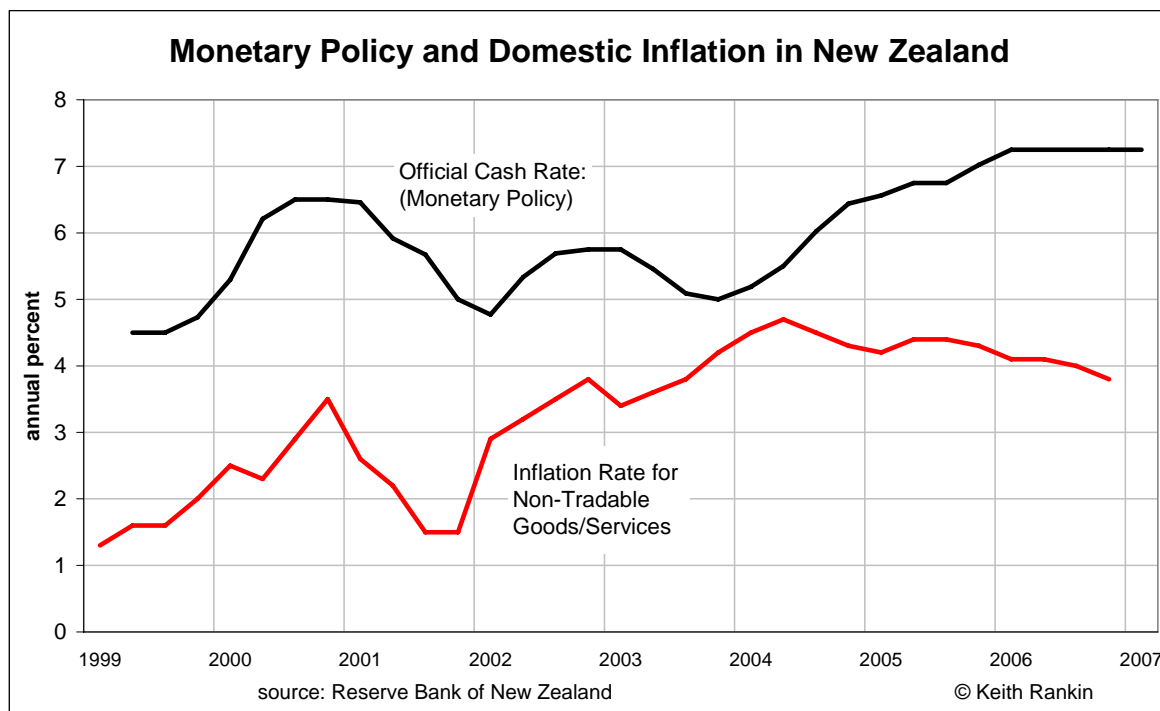
In fact, inflation in New Zealand is currently negative. The December quarter CPI was 1005, compared to 1007 for the September quarter. While the Reserve Bank conceals this point in its latest monetary policy press release, it does note that annual inflation "is projected to decrease considerably further through 2007".

Even if we do agree with the Reserve Bank that expected inflation in 2008 and 2009 is the principal problem that New Zealand's policymakers should be addressing, can we be sure that the disinflationary policy sequence (with or without a tax on mortgages) is a useful way to solve that problem? The known costs of such policies are just too great, compared to the uncertain benefits.

Businesses in New Zealand urgently need lower interest rates. While reduced interest rates might precipitate a fall in the exchange rate that could see inflation rise to 4% for a year or two (as happened in 2000), it's a small price to pay for a return to an economy with a healthy balance between the domestic and internationally-competitive sectors.

Inflation in the domestic non-tradeable sector (just over half of New Zealand's GDP) has increased markedly since 2001. While raising the OCR has caused deflation in the tradeable sector, it has been more of a cause than a cure for inflation in non-traded goods and services.

The accompanying chart, which plots the Reserve Bank's cash rate against annual inflation in the non-tradeable sector, shows two things. First, the trend increase in the OCR precedes the increase in the domestic inflation rate from 2001. Domestic inflation is markedly higher now than it was when monetary policy tightening began late in 1999.



Second, given that monetary policy is understood to operate with a lag of 1-2 years, small falls in domestic inflation have commonly followed brief easing phases of monetary policy. At present domestic inflation remains stubbornly around the 4% mark, despite policy tightening throughout 2004 and 2005, and arguably because there has been no easing phase since 2003.

Despite the recent fall in prices, the January monetary policy press release was hawkish in tone: "it is likely that further policy tightening will be required". As a result of this stance, the New Zealand dollar has been bid up this week to over 70 cents US (22 February), just what our competitive businesses do not need.

The New Zealand economy is seriously out of balance. Just one look at the balance of payments data confirms this. We must not allow the Reserve Bank to further cripple New Zealand's businesses by continuing its futile attempts to arrest the domestic housing bubble by raising the cost of finance.

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