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MONETARY POLICY: Case of much ado about nothing

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The deflationary efficacy of monetary policy is in danger of being overstated.

MONETARY policy in New Zealand is the classic modern example of the "Emperor has no Clothes" story. The present 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 a small increase in interest rates can cause any meaningful decrease in consumer spending or in the uptake of housing mortgages? And is our annual inflation rate so bad the Reserve Bank should contemplate taxing new mortgages as an alternative means of slaying this perennial dragon?

Another way of summarising the process of raising interest rates to combat inflation 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. In particular, it creates huge imbalances between our internationally competitive tradeable sector and our domestic only non- tradable sector.

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

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

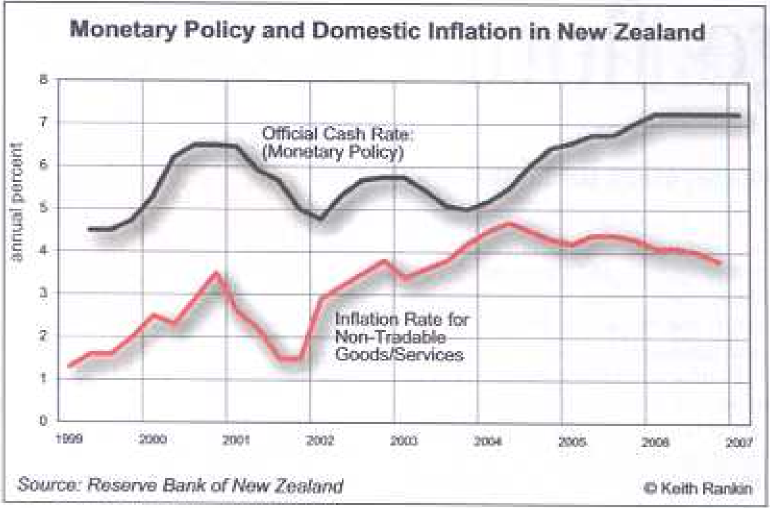
In fact, inflation in New Zealand is at present negative. The December quarter CPI was 1005, compared to 1007 for the September quarter. While the Reserve Bank conceals this point in its latest monetary policy press release, it does note that annual inflation "is projected to decrease considerably further 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 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- tradable 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 chart above, which plots the Reserve Bank's cash rate against annual inflation in the non-tradable 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.



Monetary Policy and Domestic Inflation in New Zealand
annual percent
0
1
2
3
4
5
6
7
8
Official Cash Rate:
(Monetary Policy)
Inflation Rate for
Non-Tradable
Goods/Services
1999
2000
2001
2002
2003
2004
2005
2006
2007
Source: Reserve Bank of New Zealand
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Second, given that monetary policy is understood to operate with a lag of one to two 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 $Kiwi was bid up last month to more than US70 cents, just what our competitive businesses did not need.

The New Zealand economy is seriously out of balance. A 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 housing bubble by raising the cost of finance.

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