Fixing the Mess

by Keith Rankin, 1 May 2007

There seems to be growing acknowledgement that tight monetary policy (ie the actions taken by the Reserve Bank to raise interest rates) is a flawed concept. More commentators and policymakers are accepting that, at best, that the actions of the Reserve Bank (since 2004) are creating more problems than they are alleviating. They are adding to the liquidity of the New Zealand economy, the very opposite of what a tight money policy is supposed to achieve, while crucifying service, manufacturing and primary industry businesses that export or compete with imports.

There is near-universal hand-wringing when it comes to discussing solutions. Policymakers and most other commentators say there is nothing else other than raise interest rates that anybody can do to slay the inflationary dragon, except perhaps slash government spending. (Slashing government spending, like raising interest rates, will create more problems that it will solve in today's environment. But that's another story.)

I disagree with the hand-wringers. The policy solution is not-at-all difficult, although not allowing the current economic mess to come about would have been better than fixing it after the event. Perhaps the first thing to note is that inflation in New Zealand is not a dragon; it's a pussy cat, safely under 3% as it has been for a while. Inflation is far from public economic enemy number one. Even in Zimbabwe where annual inflation is over 1000 percent, inflation is a symptom of an economic tragedy and not a problem in its own right.

(That's not to say that there are no inflationary pressures in New Zealand. We need a much more sophisticated analysis of the causes and effects of inflation than anything we are getting in what passes for economic debate in New Zealand. But that's a story beyond the scope of this article.)

What matters crucially is whether the recent actions of the Reserve Bank are creating (or aggravating) the very problem that they claim to be solving. Or is the Reserve Bank simply ineffective at dealing to the investment housing bubble that it claims to be addressing?

I argued strongly last week (www.scoop.co.nz/stories/HL0704/S00415.htm) that "the Reserve Bank, by keeping interest rates high and assuring investors that New Zealand interest rates will stay high, is fuelling rather than dowsing the investment housing fire". If I am right, then the hand-wringing is unnecessary. *The Reserve Bank can dowse the fire by doing the exact opposite of what it has been doing. It can lower interest rates*. It's that simple.

In late November and early December 2005 I wrote two articles for scoop.co.nz ("Dr Bollard and the First Law of Holes" parts one and two) with the theme that the first thing you should do when you are messing up is that you should stop whatever it is that you are doing. (The First Law of Holes is: "stop digging". It was actually Helen Clark, in either the 2002 or 2005 election campaign, who I first remember stating this fundamental law of common-sense.)

Actually, Dr Bollard did take my advice soon after that. While he foolishly raised the Official Cash Rate (OCR) on 8 December 2005, digging a bigger hole for himself, he then left the OCR alone for a year. By January 2006, financial markets had completely reversed their expectations of what would happen to the $NZ exchange rate. So they sold the $NZ, which fell from a trade-weighted-index (TWI) of 74.4 in December 2005 to a low of 60.5 in June 2006, a fall of 18.7% in six months. Then, in July 2006 it appeared to stabilise, at just the level ($US 60c) that most New Zealanders could agree was good for everyone.

Sadly, Dr Bollard then got out his spade. He started digging, not by raising the OCR, but by ruling out an interest rate cut. He also started using tougher language; language that allowed overseas investors to believe that the $NZ would be much more likely to rise than to fall in the second half of 2006. At that point the overseas funds flowed back in. Why would Japanese housewives, Belgian dentists, and Chinese tailors (see "Chinese tailor joins investor gang", *Independent Financial Review* 25 April 2006) not want to get seven percent for their money by investing it here, given the perception encouraged by Dr Bollard that the $NZ had fallen as far as it was going to fall.

It was all uphill after that. The $NZ reached a TWI of 72.2 on 23 April 2007, an almost complete reversal of its fall in 2006. Although it wasn't until 8 March 2007 that the Reserve Bank raised its Official Cash Rate to 7.5%, the general tone of the talk coming out of 2 The Terrace Wellington was that interest rates were only going one way and that was up. So the actual rates in the marketplace (90-day bills) rose steadily from 7.45% in August to 7.85% in early March, to a peak of 8.08% in late April.

Despite this, I believed that the housing bubble would subside in 2007 (see The end of the housing bubble is nigh, *Independent Financial Review* 15 Nov 2006), but only on the condition that the gap between interest rates in New Zealand and in Australia narrowed, making New Zealand a less attractive investment outlet to Australians, and making Australia a more attractive investment outlet than New Zealand to Japanese housewives. Sadly, in 2007, the trans-Tasman interest rate gap has widened significantly. Further, with the unexpectedly low recent inflation figure in Australia, there is likely to be an interest rate reduction over the Tasman, which can be expected to further fuel investor interest in New Zealand.

The 2006 experience guides us about what needs to be done in 2007. Interest rates need to be cut, by 0.25 percentage points every six weeks, until the $NZ is down to a TWI of 60 (which probably means about $US 60 cents). Dr Bollard should make it clear what exchange rate he sees as desirable, but also make it clear that, when it reaches its target value of 60, that there is no guarantee that it will not fall further. New Zealand should never be seen as a "one-way bet" by international currency speculators.

The wording of the 2002 Policy Targets Agreement (of the Reserve Bank Act) allows him to disregard inflation in the short term. Thus a brief inflationary spurt, like that of 2000, is not an unacceptable outcome even under current legislation.

In the longer term, monetary policy implementation must be changed substantially. Alan Bollard, is a "Keynesian" economist, which makes him a tinkerer, a fine tuner. In economist terms, that makes him left-of-centre. Indeed he was Michael Cullen's pick as Treasury Secretary in 1999, and Reserve Bank Governor subsequently.

The Reserve Bank needs a new, more conservative (but not monetarist!) approach. Like Alan Greenspan in the United States in the 1990s, New Zealand needs a central banker who trusts markets, who will let the macroeconomy run on for longer, and who will only intervene in a genuine emergency. (Greenspan was very quick to intervene in September 2001, as he had been in September 1987.)

There is some inflationary pressure in New Zealand. So lets turn that into a positive, as it was in the 1950s and 1960s. Interest rates rise on their own accord when there is inflationary pressure, but not nearly as quickly as when monetary policy is pushing rates up.

New Zealand needs a period of inflationary pressure without high interest rates. When wage growth outstrips the cost of the capital goods which embody new technology, then employers switch to a more capital-intensive mode of production.

That's how productivity increases happen. The market economy is better at averting inflation than is the Reserve Bank. The only way New Zealand can ever sustainably achieve the living-standards that it aspires to, is to enable significant improvements in productivity levels. Running a high-interest low-wage low-tax economy will not do that.

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