



**11 September 2008**

## **50-point cut welcome but monetary policy flaws remain**

The Reserve Bank has cut the Official Cash Rate by 50 basis points this morning providing downward pressure on the interest and exchange rates. The further decline in the economy, and particularly the housing market, left the Reserve Bank with little choice but to make a large cut despite inflation at 4.9%, well outside the target range. The New Zealand Manufacturers and Exporters Association (NZMEA) welcomes the 50-point cut but points out that its affect on the exchange rate simply serves to amplify the boom to bust economic cycle that will continue to damage the tradeable sector.

A faltering economy facing a third quarter of recession and now worsening terms of trade, justifies the 50 basis point interest rate cut. However, Cost Price Inflation is at 4.9%, well outside the 1-3% target range, which demonstrates the inability of the Reserve Bank's monetary policy tools to deal with conflicting pressures. The cut pushed the dollar down, demonstrating that the value of the dollar is driven by speculation, not the fundamentals of trade.

NZMEA Chief Executive John Walley says, "We saw a 50-point cut as necessary to provide some relief for the economy,<sup>1</sup> but conditions are still getting worse. We need to see more cuts sooner rather than later. Lets just hope that the high street banks don't hold on to the extra margin for too long and we see the cuts delivered to consumers. We don't expect to see extra spending; debt reduction and savings are the new priorities."

The fluctuations in the New Zealand dollar caused by the use of interest rates to control inflation have been punishing the tradeable sector for some years. High interest rates attract speculative foreign investment, driving our exchange rate up and making things all but impossible for exporters. When the economy starts to slow due to these high interest rates, the Reserve Bank cuts the OCR, this foreign money leaves and the dollar drops. This continuing exchange rate rollercoaster deters long-term investment in the tradeable sector, as businesses cannot accurately predict their returns.<sup>2</sup>

"It is hard to see how the negative affect on the tradeable sector can be justified when the Reserve Bank is not even meeting its own targets. Inflation has been outside the target band for some time now and the economy continues to shrink. There are other inflation control mechanisms available and they are worthy of serious consideration,"<sup>3</sup> says Mr. Walley. "The security blanket of the familiar is not the answer to a world in turmoil."

"A consensus is starting to grow amongst exporters that change is needed. Increasing dairy prices have sheltered some farmers from the effects of the exchange rate but this will not continue forever. Federated Farmers have come out in support of monetary policy changes – sooner or later all New Zealanders will recognise that they will share the fate of our external sector."

"Our continuing trade deficits spell out the need for change, we need to decide if we want to increase our wealth or continue on this downward slide."

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<sup>1</sup> 'Exports – the key to sustaining a high dollar', <http://www.mea.org.nz/document.ashx?id=353>

<sup>2</sup> 'Innovation, Growth and the High Cash Rate', <http://www.mea.org.nz/document.ashx?id=38>

<sup>3</sup> 'A Case for Compulsory Superannuation', <http://www.mea.org.nz/document.ashx?id=36>