

ViewPoint

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Turning Trade Deficits Around

An increasing current account balance deficit and a changing tide of opinion has been unable to convince the Finance and Expenditure Select Committee that changes to monetary policy are required.

At the moment Government has delegated the control of inflation to the Reserve Bank that uses interest rates in an attempt to control inflation. The Reserve Bank increases interest rates in response to rising inflation. This is intended to decrease consumer spending as higher interest rates leave mortgage holders with less discretionary income and encourage others to save. Unfortunately the same high interest rates also attract funds into New Zealand as foreign investors take advantage of them. The exchange rate rises, money flows in, credit expands the money supply – yet more inflation. The high exchange rate causes export returns to fall, creating a gap between the domestic economy, which continues to enjoy low interest rates funded by foreign credit, and the tradeable economy. At some point easy credit stalls, causing the domestic economy to feel the pain long evident in the tradeable sector. Interest rates are cut, the dollar falls, unemployment increases and credit tightens further.

Right now the cycle may be starting to favour exporters but unfortunately a number of exporters, like Fisher and Paykel, have already left. Others lack the resources, the will or the risk appetite to take advantage of increasingly favourable trading conditions.

With the exchange rate changing rapidly, an activity that was profitable when an investment was made, may cease to be profitable a few years later. This experience tends to make exporters invest in shorter-term projects to avoid this exposure. Unfortunately, these short-term projects do not involve the same investment in people, plants and products and therefore do not generally increase productivity or generate the same benefit, over time, to the economy.

For sustained growth we require more stability for tradeable activity so that firms will take on longer-term risks to export. A trade based dollar value (a value determined by the value of exports in comparison to imports) is the point where both importers and exporters can succeed. Too much speculative variation either side of this position places too much pressure on the disadvantaged sector. If the problem persists, investment decisions will shorten, slow or even stop, as the sector becomes more risk averse.

Opponents of the current monetary policy framework wanted:

- wider inflation targeting considering other economic indicators, and
- a different mechanism to fight inflation.

The group that sought looser inflation targeting wanted to see increased emphasis given to other factors such as employment, export growth and productivity. They argued that this would create a more balanced economy and counteract the cyclical affect of simply inflation targeting. The group thought that better economic growth could be generated by this approach, increasing the supply side of the economy and therefore, decreasing inflation.

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The use of variable GST rates and Interest Linked Savings Schemes were proposed as alternative methods to interest rates to control inflation. These systems would have similar affects to changing interest rates, as they would reduce the supply of money available when inflation expectations were high, however, they would remove the foreign speculative pressure on the exchange rate.

In rejecting change the Select Committee argued that the costs and uncertain returns of alternative inflation control mechanisms outweighed the positive affect of removing the speculative pressure on the exchange rate. This was a highly contentious finding given that no cost analysis had been attempted on any of the options presented to the Select Committee over the year it took to produce the report. Although the effect on the exchange rate was acknowledged, there was also no consideration given to the cost of maintaining current policies to the economy – a \$3.9 billion dollar trade deficit in the June quarter.

Further, the view was that adjustments to factors considered by the Reserve Bank were unnecessary because the Reserve Bank already considers the impact of output, interest rates, and the exchange rate. The exchange rate variations since the Reserve Bank Act was introduced would suggest that these are not serious considerations, as exchange rates have fluctuated wildly.

The Interest Linked Saving and the variable GST rate schemes proposed, along with a variable savings rate scheme, even the variable excise duty approach proposed by Don Brash would break the link between reducing the money supply and the exchange rate. This would negate the negative affect on our tradeable sector and reduce our reliance on foreign debt funding, which makes us highly vulnerable to global credit problems. Multiple economic targets rather than simply inflation targeting would also be beneficial as this would allow the Reserve Bank to counteract the business cycle that causes volatility.

The Select Committee report is a lost opportunity to make some real changes to New Zealand's economic outlook. However, the submissions made to the Committee have formed a body of opinion that will be difficult to ignore in the face of policy failure.

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