

ViewPoint

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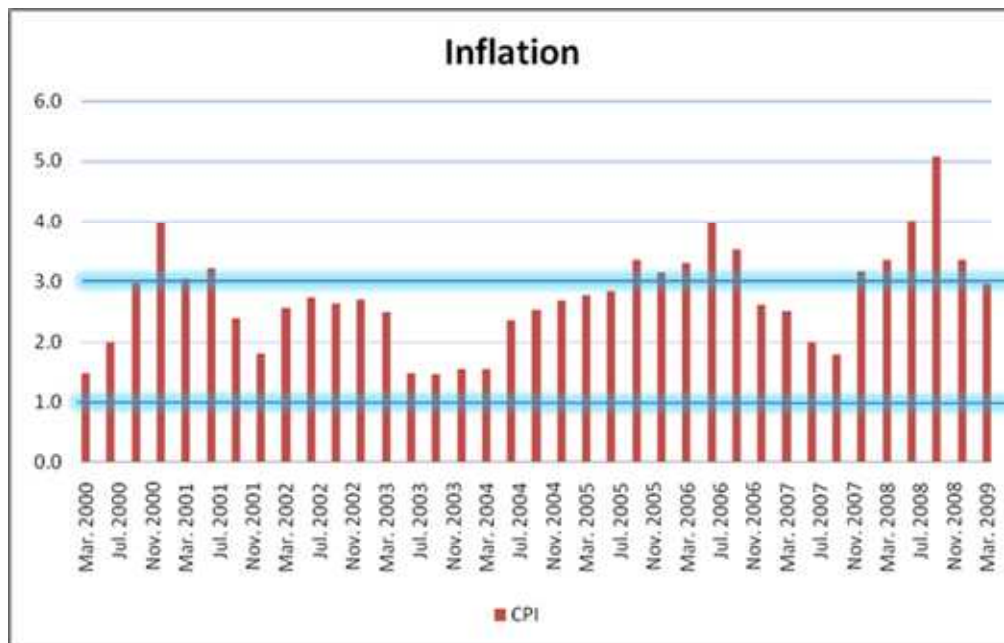
Monetary Policy – has it worked?

I recently attended the New Zealand Association of Economists' Annual Meeting where there was a good deal of discussion around the causes of the financial crisis, and how our own approach to monetary policy operated and resonated with the choices of other jurisdictions.

David Preston offered a good appraisal of our monetary policy in his presentation entitled Putting Credit Back into Monetary Policy. His argument was that if you measure the success of monetary policy only by the objectives set out in the Policy Targets Agreement then it has been fairly successful, but if you measure success according to wider economic objectives then it has failed.

A quick look at this inflation chart would lead to the conclusion that the Reserve Bank has kept inflation in the target band over the medium term. A success? Well maybe.

How does our monetary policy operate and resonate with other jurisdictions?



If we look a little deeper and disaggregate the inflation of the tradeable and non-tradeable sectors and add a few other characteristics, we see a very different picture.

Inflation, Money Supply and the OCR



“The non-traded economy that is responsible for inflationary pressures has been largely unaffected by the OCR”

It would seem the Official Cash Rate (OCR) has little impact on inflation in the non-tradeable sector. Non-tradeable inflation is consistently outside the target band. Tradeable inflation has fluctuated wildly over the same period, but has averaged only 1.7 percent, well within the target band. Monetary policy has constrained the tradeable sector via interest rates and the secondary but major impact of the exchange rate.

The non-traded economy that is responsible for inflationary pressures has been largely unaffected by the OCR. As Preston noted, the price of credit moved up with the OCR but this was also a period of rapid credit expansion. From May 2004 to May 2009 the money supply expanded at an average of 8.9 percent. Our high interest rates allowed banks to source credit from overseas to fund local asset backed borrowing. Borrowers were largely undeterred by the interest costs because asset prices continued to rise, (well supported by their asset tax haven status) more than offsetting the higher interest bill.

So what can we see:

- The exchange rate has fluctuated wildly as global capital flows chase our OCR movements.
- A large proportion of debt in New Zealand has flowed towards asset tax havens (land and buildings) where the increased interest costs could be covered: that caused the imbalance we see in our economy.
- The OCR has next to no impact on the non-traded economy.

“The exchange rate has fluctuated wildly as global capital flows chase our OCR movements.”

These problems will continue until the rules change. The attempts to control inflation have failed; inflation has only been brought within the target band by almost killing the tradeable sector while inflation in the non-traded economy is demonstrably impervious to interest rate pressure.