



IS THERE AN ALTERNATIVE TO PRESENT MONETARY POLICY?

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- BY WHICH MOST BUSINESS PEOPLE MEAN ONE OR BOTH OF TWO THINGS:

* SHOULDN'T THE RESERVE BANK PAY MORE ATTENTION TO GROWTH AND EMPLOYMENT, AND LESS TO INFLATION?

* SHOULDN'T THE RESERVE BANK PAY MORE ATTENTION TO THE EXCHANGE RATE?

NOT A NEW QUESTION:

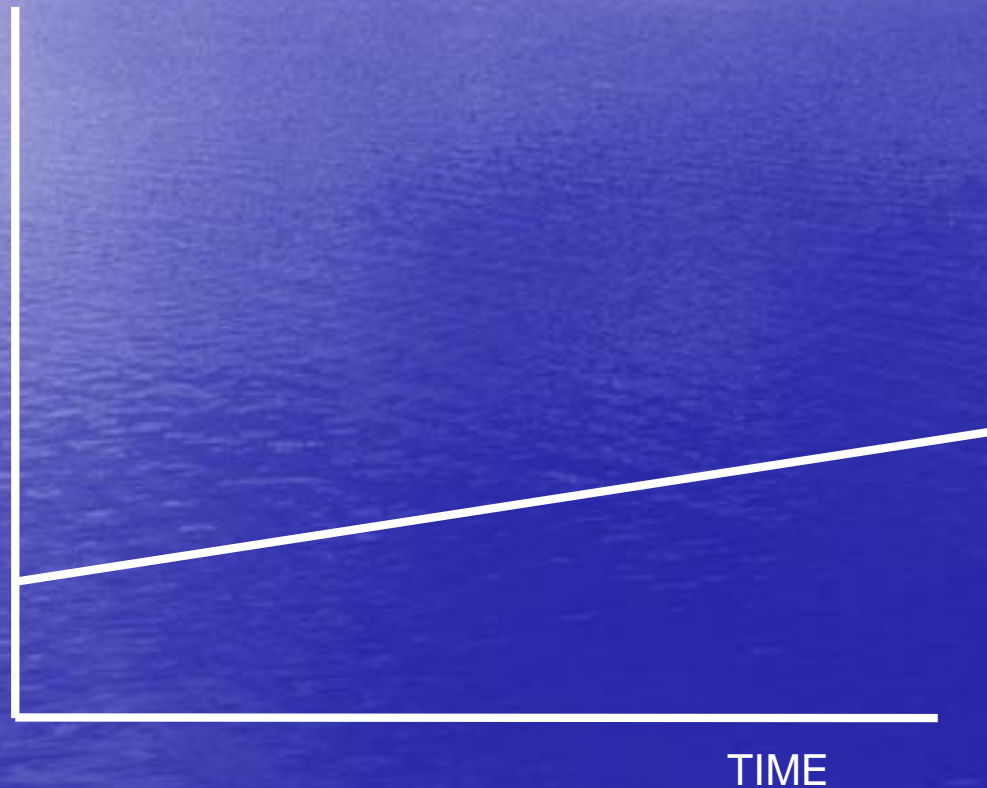
- Lars Svensson review in 2000, undertaken at request of new Labour Government
- Review by Finance and Expenditure Committee of Parliament in 2007-08 (aided by former Deputy Governor of the Reserve Bank of Australia)
- Both reviews concluded that the New Zealand approach to the formulation and implementation of monetary policy was world's best practice, and should not be changed

The Federal Reserve Board, the European Central Bank, the Bank of Japan, the Bank of England, the Reserve Bank of Australia, the Bank of Canada and the Reserve Bank of New Zealand ALL –

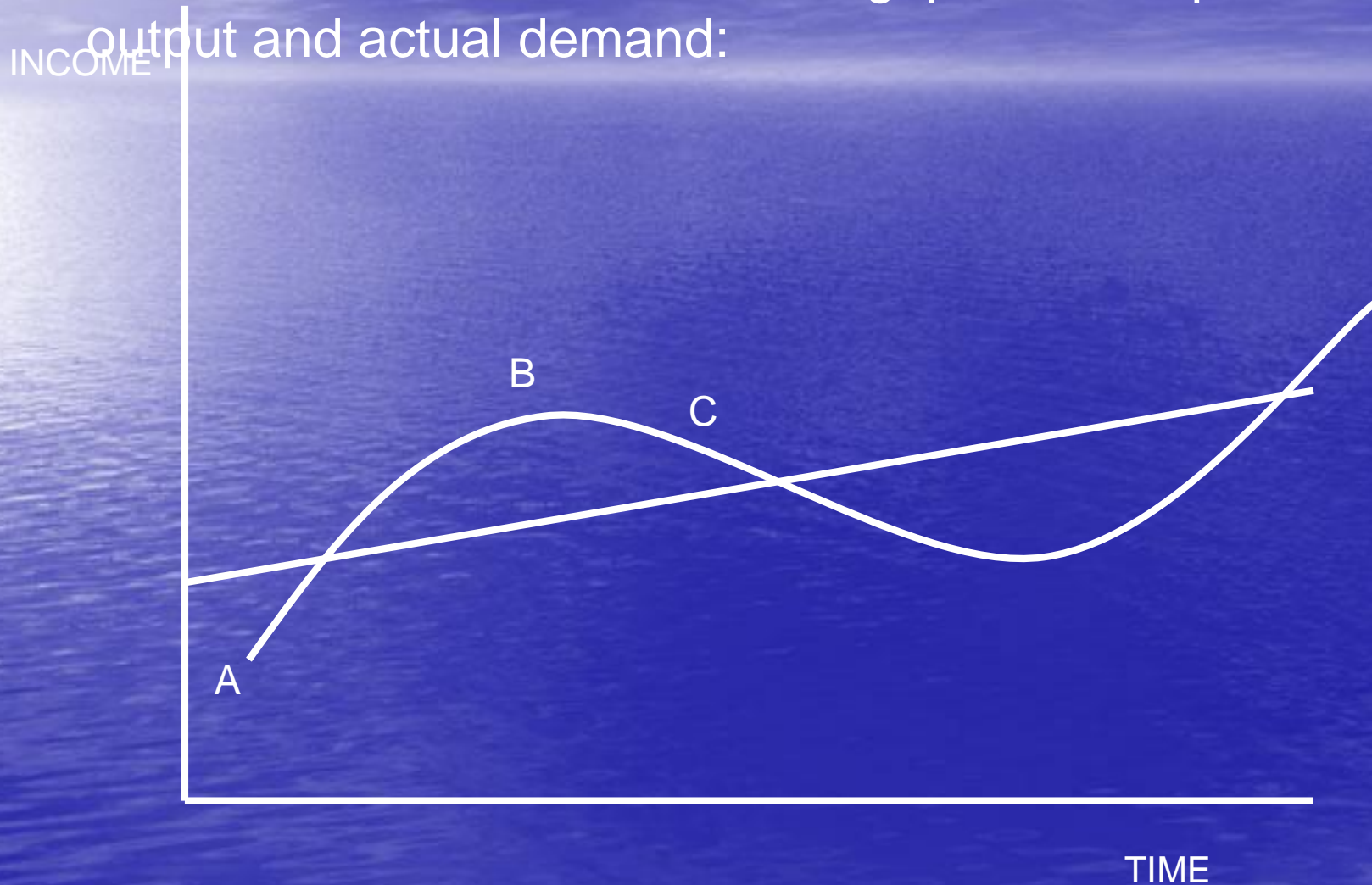
- FOCUS MONETARY POLICY ON THE CONTROL OF INFLATION (though with some differences in rhetoric because of historical differences in legislative frameworks), AND
- USE A SHORT-TERM INTEREST RATE IN ATTEMPTING TO ACHIEVE THAT CONTROL

Central bankers see trend growth in output as being a function of growth in labour inputs and growth in productivity, with no evidence that devaluing money can sustainably increase either, and some evidence that it can have the opposite effect:

INCOME



Once low inflation has been achieved, and inflation expectations made consistent with that, central bankers see inflation as a function of the gap between potential output and actual demand:



So in seeking to stabilise inflation, the central bank is also likely to be stabilising demand at around the economy's trend growth potential

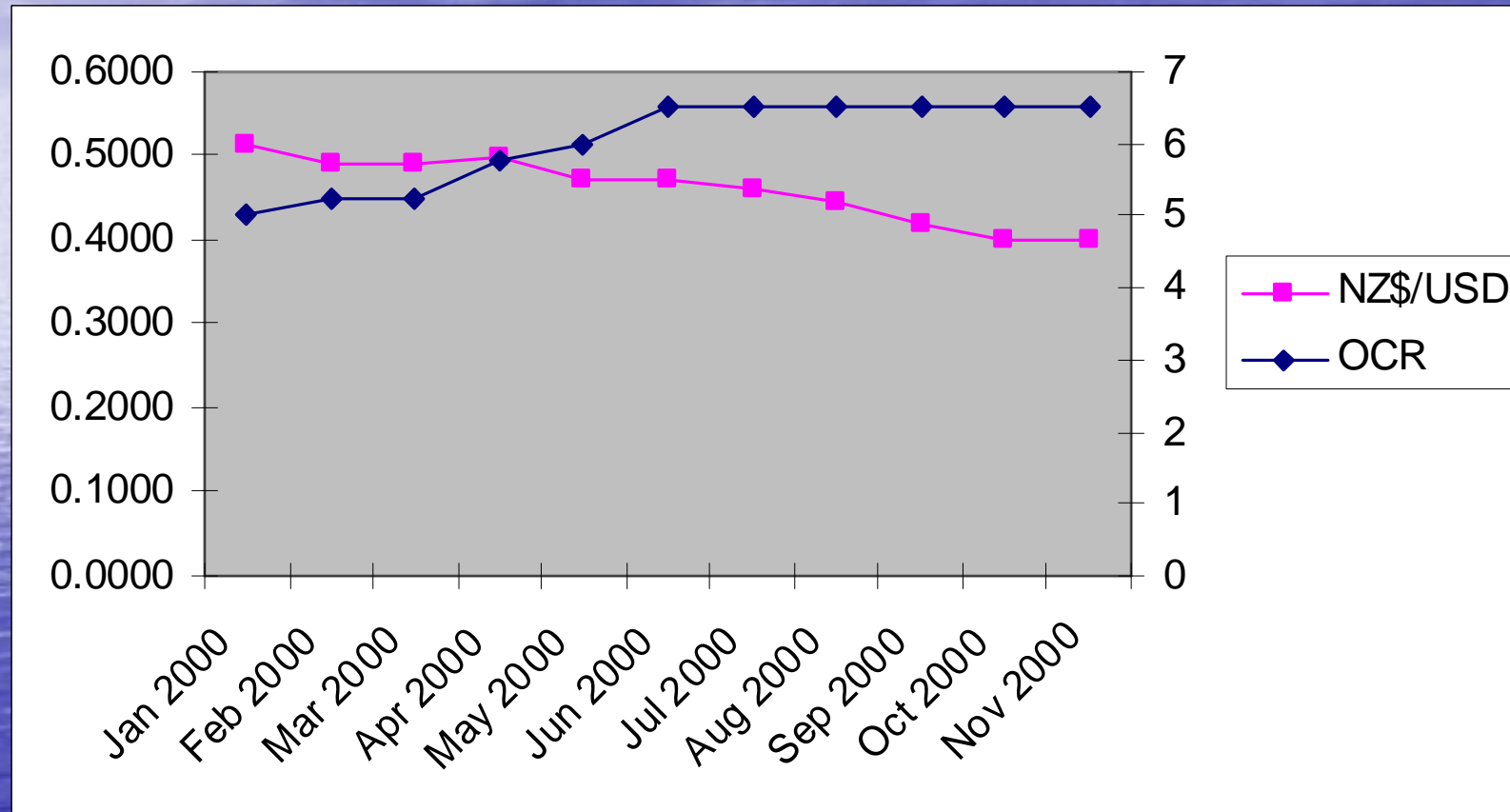
NOTE: The long-term rate of unemployment is not a function of the inflation rate, but of the relationship between the productivity of the work-force and its cost – and so is influenced by the minimum wage, labour market institutions, benefit levels, etc.

When the central bank wants to reduce the level of demand in the economy in order to reduce the inflation rate, it raises its policy interest rate (the OCR in New Zealand). This has the effect of:

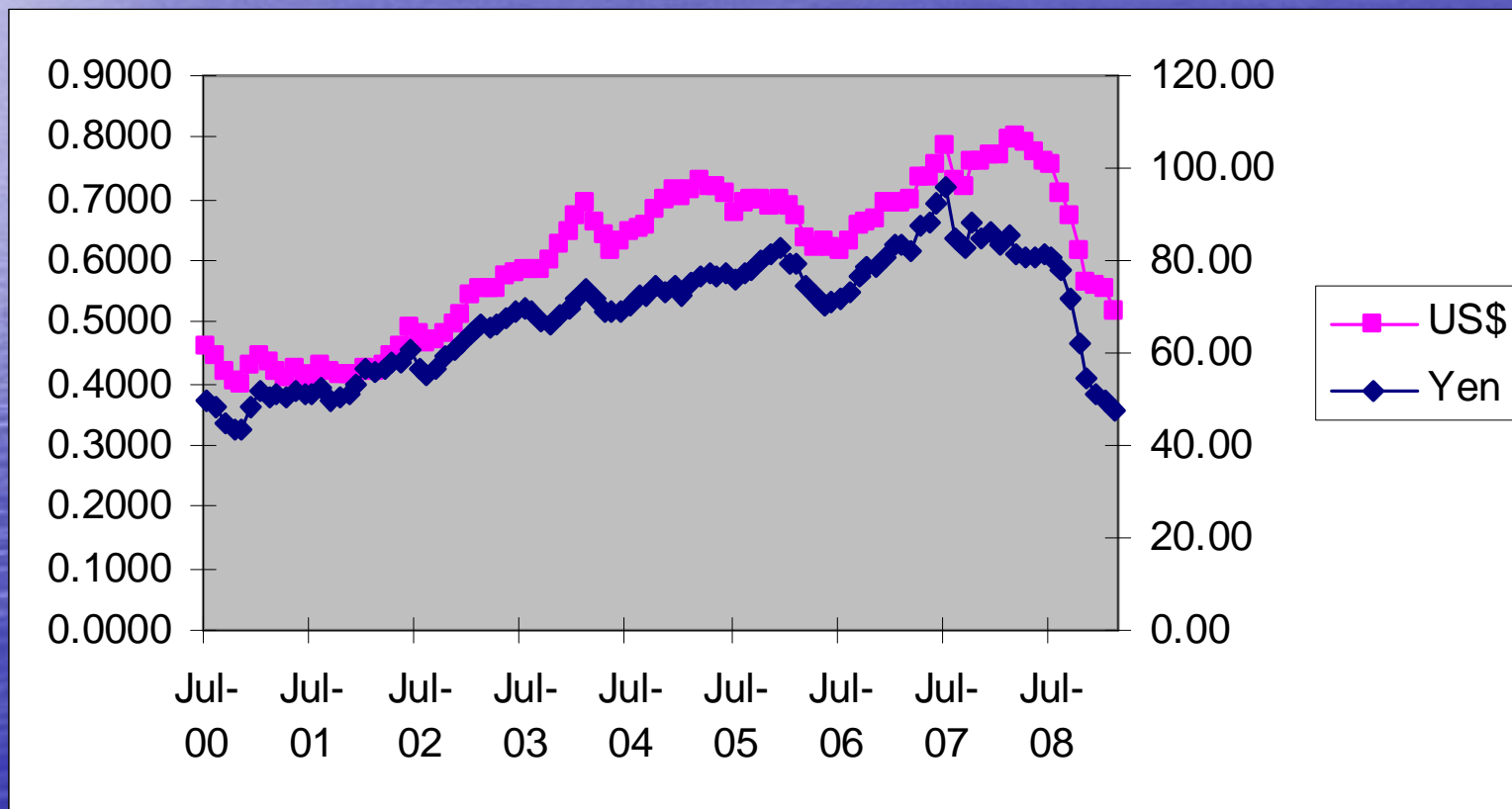
- Discouraging borrowing
- Encouraging saving
- Dampening optimism
- POSSIBLY raising the exchange rate

Because the exchange rate has powerful direct and indirect effects on inflation, a central bank ALWAYS looks at what the exchange rate is doing in setting monetary policy (remember the MCI)

The relationship between OCR and NZD not as straightforward as some believe:



But the NZ dollar certainly swings around (as do ALL floating rate currencies):



WOULD IT MAKE SENSE TO USE INTEREST RATES TO TARGET **BOTH** INFLATION AND THE EXCHANGE RATE?

UNFORTUNATELY, THAT WOULD NOT WORK.

THERE'S PLENTY OF THEORETICAL AND PRACTICAL EVIDENCE THAT YOU CAN'T TARGET TWO OBJECTIVES WITH ONE INSTRUMENT (though central bankers might like it, because they would always have an excuse for not meeting one or other objective)

HOW ABOUT USING MONETARY POLICY TO TARGET JUST THE EXCHANGE RATE?

It's certainly feasible to use monetary policy to keep the NOMINAL exchange rate stable (if used sufficiently aggressively), but it isn't the nominal exchange rate which matters for exporters or those competing with imports – it's the real, or inflation-adjusted, exchange rate.

(When the NZD was at US\$0.80, we felt it was far too high. But in 1973 it reached US\$1.48!)

If we want to control inflation AND reduce the amplitude of the cyclical exchange rate swings, two instruments are needed

- Hence my proposal to give the Reserve Bank an ability to raise or lower the excise tax on fuel (raising the excise tax when needed to dampen down demand, in lieu of SOME of the increase in interest rates, and lowering it when needed to stimulate demand, in lieu of SOME of the decrease in interest rates).

IN SUMMARY:

- The way monetary policy is practised in New Zealand is absolutely consistent with world's best practice
- There's no evidence that an easier monetary policy can increase our trend growth rate
- Nobody has yet found a way of dampening exchange rate swings (without imposing tight controls on capital movements), but because of the damage those swings do, I'd certainly favour a search for ways of doing that