

## WOULD GIVING THE GOVERNOR POWER TO VARY THE EXCISE TAX ON FUEL REDUCE THE AMPLITUDE OF EXCHANGE RATE FLUCTUATIONS?

About a month ago, I was prompted to write an article for the *New Zealand Herald*<sup>1</sup> by two questions asked of me by an exporter: why are New Zealand interest rates so high compared to those in the rest of the developed world, and why doesn't the Reserve Bank reduce the interest rate which it controls to get the exchange rate down, for the benefit of exporters?

Most readers of *Asymmetric Information* will understand why our interest rates are high compared with those in other developed countries – inflation pressures are also stronger than those in other developed countries, and the Reserve Bank is leaning against those pressures in the only way it can, by maintaining a relatively high OCR.

But how do we deal with the strong exchange rate? Indeed, is there anything at all we can or should do to reduce the high exchange rate, to the benefit of exporters and those competing with imports? Nobody seriously doubts that at current levels the exchange rate is putting quite severe pressure on most export sectors, with the obvious exception of the dairy industry, which has been protected against the effects of the high exchange rate by historically very high international dairy prices.

To the non-economist, the solution is simple: just have the Reserve Bank drop the OCR and all those nasty types investing in the New Zealand dollar will take their money elsewhere and the New Zealand dollar will fall. But of course economists know that that is no answer at all. With inflationary pressures already strong, dropping the OCR would simply intensify those pressures. In no time, exporters who might now regard a New Zealand dollar equal to 65 US cents as very attractive would be complaining that, because of higher inflation in New Zealand than in our trading partners, they need a still lower exchange rate – perhaps one equal to 55 US cents. What matters, in other words, is the level of the real (inflation-adjusted) exchange rate, not the nominal exchange rate, and dropping the OCR in the face of strong inflationary pressures is most unlikely to reduce the real exchange rate other than very temporarily.

It is worth noting that, contrary to the popular myth, the exchange rate is not always tightly linked to New Zealand interest rates. It is not even always tightly linked to the difference between New Zealand interest rates and those in other countries. In 2000, I well recall that the OCR was increased from 4.75% at the beginning of the year to 6.5% in October, while the New Zealand dollar fell steadily throughout the year to its lowest level ever against the US dollar (below 39 US cents). To be sure, US interest rates were relatively firm at that time also, but Japanese rates were then, as now, very close to zero. Both the Reserve Bank of Australia and the European Central Bank had a similar experience in 2000, with rising interest rates associated with weakening currencies.

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<sup>1</sup> 7 February 2008.

Clearly, other factors are also at play, including in particular market expectations of *future* movements in interest rates. If the market expects interest rates to be lowered in the near future, almost whatever their absolute level, the exchange rate is likely to start depreciating, and vice versa.

So how do we change expectations of future interest rates? One way would be to aggressively *increase* the OCR to make it unambiguously clear that the Reserve Bank was deadly serious about eliminating inflationary pressures. It is at least quite possible, and I believe probable, that far from pushing the exchange rate even higher that would have the effect of starting the New Zealand dollar on a downward track as markets recognised that it would not be long before the Bank was forced to start reducing the OCR again.

Another way would be to take the heat out of current inflationary pressures by tightening fiscal policy. But any general tightening of fiscal policy is difficult to do at any time, and must be regarded as a political impossibility in an election year.

Could there be scope for some new instrument? The Treasury and the Reserve Bank have canvassed various possibilities, and none creates huge enthusiasm. The idea of a mortgage levy was suggested as one way of pushing up the cost of borrowing without making the New Zealand dollar still more attractive to international investors, but the suggestion went down like a lead balloon, not least because of the way it was sold: the public saw the suggestion as an additional cost of borrowing, rather than as an alternative to still higher interest rates.

Some years ago, Federated Farmers suggested varying the GST rate as a way of supplementing changes in interest rates. Professor Lawrence Ball noted at that time<sup>2</sup> that increasing GST in an attempt to reduce spending would have the disadvantage of actually pushing up measured inflation, and so further inflaming inflationary expectations. But to me, the bigger objections to active use of the GST to reduce or increase domestic spending are different: frequent changes of the GST rate would greatly increase the compliance costs involved in that tax, and could lead to destabilizing fluctuations in spending as consumers tried to anticipate changes in the tax.

Professor Ball suggested that the power to make temporary changes to the income tax rate be delegated to an independent body he called the Macro-economic Policy Committee, possibly chaired by the Governor of the Reserve Bank, and he felt that that would moderate the swings in the exchange rate caused by the sole reliance on interest rates to control inflation. On the face of it, that would indeed moderate the swings in the exchange rate, but even frequent changes in the income tax rate would, in my view, involve quite substantial compliance costs.

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<sup>2</sup> *A Proposal for the next macro-economic reform*, Victoria University of Wellington Foundation, 11 November 1996. In my 7 February 2008 *Herald* article on this subject, I wrongly attributed to Professor Ball the suggestion that GST be varied as a way of moderating swings in the exchange rate: in fact, he rejected that idea, and I apologise to him for this error.

As an alternative, I think we should give serious consideration to giving the Governor authority to vary the excise tax on fuel. Demand for fuel is highly inelastic in the short run, so that fluctuations in the price of fuel would not lead to big fluctuations in the volume of fuel actually sold. But precisely because demand for fuel *is* highly inelastic in the short run, changes in the price of fuel would drive changes in other consumer spending. Consumers forced to pay more for petrol would to some extent be obliged to cut back on their spending on other goods and services, not unlike they are obliged to do when interest rates go up.

Since the *Herald* published my article suggesting this, a number of objections have been raised.

One person assumed that I was recommending that interest rates no longer be used as a monetary policy instrument, or indeed should be reduced to zero. On the contrary, interest rates would continue to be used, but if the excise tax were used as well, it should be feasible to reduce the amplitude of interest rate movements, with a consequential reduction in the amplitude of exchange rate swings.

Others expressed concern about the constitutional implications of giving authority to the Governor to vary a tax. I agree with those concerns, and there would clearly need to be tight constraints around any such authority, perhaps by insisting that over a specified number of years the fiscal impact of such variations in the excise tax would need to be neutral. In other words, any revenue raised when there was a need to restrain inflationary pressures would need to be offset by revenue “lost” when inflationary pressures were weak. It is worth recalling that for many decades, in New Zealand and most other developed countries, the idea of giving authority to vary interest rates to a non-elected person would also have been looked at askance, and yet that is now regarded as absolutely sensible in a situation where we recognise that monetary policy is tailor-made for the cynical politician intent on winning election every three years.

Letters to the editor have expressed concern that increasing the excise tax on fuel would particularly hurt low-income New Zealanders. Certainly, low-income New Zealanders would be adversely affected by such a move, but then of course they are also hurt when the Reserve Bank is forced to raise interest rates, both directly and, if they work in export industries, indirectly. We are not comparing an added tax on fuel with a situation where interest rates remain unchanged: we are comparing the impact of an increase in the price of fuel on the one hand with the impact of higher interest rates on the other.

Still others have objected to the fact that my proposal is an “intervention”. Well, yes, it is of course. All monetary and fiscal policy moves are “interventions”. The challenge is to find those interventions which do the maximum of good and the minimum of harm. To me, giving the Governor authority to vary the excise tax on fuel would reduce the need to move the OCR quite so aggressively, and would therefore have the huge benefit of moderating swings in the real exchange rate.

Professor Ball might well object that increasing the excise tax on fuel would increase measured inflation, and so inflationary expectations. And that is certainly true – indeed, that was a problem we had in New Zealand when the CPI as measured by the Government Statistician included changes in interest rates: when interest rates were increased to reduce inflation, the measured inflation rate actually increased for a time.

But if somebody has a better idea, let's hear it!

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