

Address by Hon David Parker to the New Zealand Manufacturers and Exporters Association in Auckland on 22 June 2010

Monetary Policy Reform for an Export led Economy: Labour's direction

Thank you for the invitation to be here today.

Today I will address monetary policy.

I am aware your organisation has been a leader in the debate about monetary policy and has strong views, born of your practical experience of the detrimental effect current policy has had on our export sector. Thank you for your contribution. Your organisation has correctly identified that the interests of exporters are not the same as those of importers, the property sector, retailers or banks. For this reason you have chosen to present your case separately from the generic business lobby groups, whose members are less focused on the export economy. This has been an important step.

It is important that monetary policy should not undermine our export manufacturing sector. I recently saw a presentation from Dr Rick Boven from the New Zealand Institute. His analysis of the NZ economy of more successful economies showed that NZ cannot bridge that gap with Australia or other developed countries by increasing agricultural output, nor through mining (which represents about 10% of the difference). Without diminishing the importance of our pastoral and extractive industries, it is very clear that for NZ to catch up we need more high value exports. Our economic policy settings should not hinder that. Currently they do in a number of areas. I will concentrate today on monetary policy.

As you will be aware, last year the Labour Party withdrew from the cross-party consensus on monetary policy. Labour believes it is in need of reform, and has been one of the underlying limits to our economic performance relative to wealthier developed countries.

The National Party response to our initiative was to assert that NZ has the best monetary policy in the world, and that no change is needed. Since then the IMF has come out on our side, so we are in good company. Our views are credible.

I will begin today by recounting the history that led to the Reserve Bank Act in its current form in 1989, before describing some of the adverse side effects of current policy.

Then I will set out the changes we propose, list the alternatives which we do not intend to pursue further, and those which are still under consideration.

First a bit of history. A global energy crisis occupied the minds of Governments in the late 1970s. In New Zealand pink "Thursday" stickers appeared on our windscreens marking the ill-fated carless days. More significantly, the National government promised 400,000 jobs for New Zealanders who dared to 'Think Big'. In the wake of the divisive Springbok tour, New Zealanders went to the polls with inflation running at over 15 per cent.

By 1983, double-digit inflation had been running for a decade. Wages had failed to keep pace. A year earlier the National Government had responded with the most dramatic peace-time price and wage freeze. It failed. The economy stalled and the Government's financial position was in free fall. There was a run on our currency. Interest rates for home loans hit 20 per cent by the mid-1980s.

The efforts of the Reserve Bank to rein in inflation were formalised by the late 1980s. By then New Zealand had been suffering from high and erratic inflation averaging between 10 and 15 per cent for close to two decades. The Reserve Bank was given independence and the mandate to pursue price stability to preserve New Zealanders' purchasing power. Its obligation to protect the stability of our financial sector was retained, an issue I will return to.

The pursuit of lower inflation was not without cost, but by the early 1990s low inflation had been achieved. As the Reserve Bank observes, "*it has since become a well-entrenched feature of the economic landscape*". The importance of controlling inflation is a lesson of history well understood. We remain committed to an independent full service Reserve Bank.

I mention our history to remind us all that a high and volatile exchange rate is not the only economic setting that hurts the tradeable/ export sector. High inflation, especially in the absence of any capital gains tax, encourages speculative investments in land to the detriment of investment flows into capital equipment. The high interest rates associated with high inflation also increase the cost of investing in that capital plant which we all know is needed to improve productivity and maintain export competitiveness.

The crippling effect of high and volatile inflation is uncontested. But it is at the very least arguable that the NZ prescription of monetary policy was applied in too draconian a fashion in NZ in terms of how high interest rates were pushed, and in too lax a fashion in terms of credit flows into New Zealand.

We do have a tendency for policy extremes in NZ. Other countries achieved control of inflation without interest rates staying higher than international averages over time. The international trend was for lower inflation over this period anyway, and some inflationary pressures would have abated even without the Reserve Bank Act.

So while the success of the Reserve Bank Act 1989 is reasonably clear - low and stable inflation - it is important that we are not blind to the limits and side effects of monetary policy and reflect on ways we could do better.

I was first elected in 2002 and during my first three years in Parliament sat on the Finance and Expenditure Select Committee hearings held when the Reserve Bank quarterly announcements were made. I re-read transcripts from that period recently. Three points stand out for me:

- I was concerned that entrenched higher-than-overseas interest rates were exaggerating extremes in our currency.
- I was emphasising my view that those interest rate differentials were also driving liquidity into NZ via banks borrowing overseas at lower rates and profiting by the margin on their increased lending in New Zealand. It seemed to me that this increase in mainly residential mortgage and credit card lending was in fact fuelling the very consumption pressures (and asset price bubbles) that higher interest rates were meant to curb.
- John Key was already warning about the risky lending in the finance company sector, which was forced into the riskier end of the market as the banks expanded into areas traditionally serviced by secondary lenders.

History shows some of your politicians have been concerned for some time.

I don't want to be too critical of the Reserve Bank or the Treasury. The imbalances in the NZ economy which have led to overinvestment in property and dis-saving are not all their fault. The Bank has in recent years said "monetary policy needs friends" and pointed out that NZ is rare in not taxing capital gains, while allowing interest costs to be written off against other income. And the Treasury in the end did support measures to improve our abysmal savings and investment record – truly the most significant difference between the NZ and Australian economies. (As an aside if you doubt that, reflect on the fact that the combined profits of the four major banks currently exceed the total profits of the rest of the NZX50. And then ask yourself how it has come to pass that the Australians own not just their own banks, plus ours.)

Back to monetary policy. It is interesting to reflect that, until recently, both the Treasury and the Reserve Bank were in my opinion too sanguine about our current account deficit, and the increasing contribution to that deficit of the now enormous interest and dividend flows to overseas lenders and owners.

I thought the explanation for higher NZ interest rates of overseas which the Bank started to talk about around 2003 or 2004 was trite. They began to justify NZ's higher interest rates of our competitors by saying that NZ's high levels of private debt meant a premium would have to be paid to overseas lenders, but never acknowledged at the time that their policies contributed to this outcome. That result, for me, is another pointer to a failure in monetary policy to achieve a balanced outcome. I am not persuaded that our regulators and advisors saw this in advance. I think some of our politicians and business leaders were ahead of them.

The effect of current settings on the tradeable export sector have been outlined well by your Association and by BERL. I will not rehearse them, suffice it to say I agree with their concerns.

My concerns about current settings have been reinforced by the steps the government had to take following the financial crisis. Our banks are so reliant on overseas credit lines that the NZ taxpayer had to guarantee both wholesale and retail deposits by overseas lenders, as well as make loans to the trading banks secured by bundles of mortgages. We also saw the widespread collapse of finance companies, which in turn caused a need for Crown guarantees in this space as well, with distortionary effects that I don't have time to describe today. I don't put too much emphasis on this given similar outcomes overseas, but again our regulators and the Treasury are wise with hindsight.

I am dismayed that the regulators of finance companies failed to properly protect our investors against the robbery caused by related party lending and by the distributions of fictitious profits to directors and owners at the expense of ordinary investors. I am not suggesting that regulators can or should avoid risk-taking by investors, but some of the excesses of recent years should have been prevented, especially where the wide-boys had prior form.

The collective failure of our institutions to use foresight to limit the asset price bubble and better protect the integrity of our financial institutions does give credence to the Labour Party's view that this area of policy is in need of review. The recent financial crisis has served to emphasise the crucial role played by financial intermediaries in keeping the wheels of commerce turning. While NZ may have fared better than some countries, our performance was far from perfect.

Recent experience has emphasised the clear weaknesses in the current structure. Along with low inflation, it has delivered entrenched higher interest rates and contributed to a volatile currency at the expense of our productive sector.

Until just a few years ago the New Zealand economy was inflated by a river of money pouring into the country to take advantage of high interest rates relative to elsewhere. While banks aggressively competed against one another offering more money to home owners and farmers, the resulting high and volatile exchange rate squeezed exporters. The Reserve Bank had no answer.

In a short space of time that problem abruptly evaporated and the onset of a global financial crisis laid bare the inverse concern that no one would lend us the money we need to feed our current account deficit addiction. Global financial instability, the collapse of our own finance company sector and the inflation of a property bubble contributed to the destabilisation of our banking system to such a serious extent that the Government was required to step in to ensure its survival.

It is clear persistently high interest rates are imposing significant costs on our economy. New Zealand exporters are at a disadvantage against overseas competitors who are able to fund their activities at a lower cost.

Also, foreign investors with access to cheaper capital have a distinct advantage over any New Zealand party forced to borrow at higher rates when bidding for a New Zealand business. . Other factors being equal, the overseas purchaser can afford to pay more than a NZ buyer sourcing its funds from NZ lenders. How can this be in our national interest?

Until recently the Reserve Bank denied any strong relationship arising from the differential between domestic and international interest rates, and the flow of capital into the country. But it is clear that this has happened.

Recent events have presented us with a new reality; a new environment in which the economic significance of our exporters has never been greater. We must earn our way in the world by selling more. We must rebalance our economy. This is a problem that cannot go unchallenged.

We want to rebalance the economy, by improving the relative competitiveness of our export sector - both internally relative to other sectors of the economy, and internationally vis a vis our competitors.

Monetary policy is only part of the answer, but Labour agrees with you that it is a significant part that should not be ignored.

Labour is not soft on inflation. We know that inflation can have a devastating effect on the standard of living of New Zealanders, especially those on a fixed income who struggle to have anything left over at the end of the week, and so will not be part of the speculative economy.

Labour is not seeking to penalise savers at the expense of borrowers. We realise the importance of increasing savings in the New Zealand economy. This should not mean structurally higher interest rates in NZ than overseas.

What recent changes are working well?

Focusing on the medium term, not the short term, helps.

During the term of the last Labour Government we introduced several improvements to the way the Reserve Bank operated. In September 2002, the Policy Targets Agreement was changed so that the Reserve Bank is required to take a forward looking, medium-term approach to achieving price stability. This gives the Bank more flexibility to decide how it responds to shocks in the economy and inflation variations around the target. The importance of this can be seen in the way the Reserve Bank is approaching the inflation spike the National Party government has created this year. In its latest Monetary Policy Statement the Bank has said:

The Policy Targets Agreement (PTA) defines the Bank's price stability target in terms of the All Groups, or headline, CPI. However, it also instructs the Bank to focus on the medium-term trend in headline inflation, and lists changes in indirect taxes and significant government policy that directly affect prices as specific reasons why headline inflation might vary around its medium-term trend. As such, monetary policy will not attempt to offset the direct inflation impact of the coming policy changes.

Put simply, without Labour's 2002 change, New Zealanders would probably be faced with the double-whammy of rapid interest rate rises to tackle the effects of National's inflationary policies.

But other problems remain

Many of you will know that the New Zealand dollar is one of the most traded currencies in the world. The Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, by the Bank for International Settlement in 2007 found the New Zealand dollar to be the 11th most traded currency.

The survey found the NZ dollar was traded more than the Mexican peso and the Singapore dollar. But it doesn't stop there – it was more traded than the South African rand, the Indian rupee and the Brazilian real. These are the currencies of economies vastly bigger than ours.

Weighted by population, trading of the NZ dollar ranked in the top four traded currencies. Doesn't that seem strange to you?

This heavy trading is reflected in a highly volatile currency. This volatility makes doing business more difficult for our exporters. Some economists have noted that commodity prices act as a partial hedge. While this may be true for some major primary products with a large impact on our trade balance (eg dairy), it seems less likely to be true for non-primary produce manufactured goods or for services.

As your organisation has noted, manufacturers in NZ face higher risks when investing in sophisticated plant. In addition to paying higher interest rates, you are competing against manufacturers overseas who do not face the currency fluctuations faced here in NZ. This is an extra risk for NZ manufacturers that we should try to minimise, so as to make your businesses

less risky, more likely to profit and therefore more attractive for the investment you need to make to expand.

Labour believes that New Zealand must have monetary policy which supports the long and medium term ambitions of New Zealand, not just the short term advantage of the currency traders.

Our objective in pursuing monetary policy reform is to ensure greater stability in the New Zealand currency to relieve pressure on our exporters and allow them to compete strongly.

We are not trying to set our exchange rate at an unrealistic rate – we've seen this tried and failed before. New Zealand is a small country with limited financial reserves. If George Soros can beat an artificial rate in the UK, he could beat the NZ Reserve Bank before breakfast if it tried to support a rate that was out of line with economic fundamentals.

But this is not an excuse to do nothing.

So what would we do next?

While we are not signalling today that we would go the route of Singapore (which manages its exchange rate within a declared range), we do think the interventions by the Reserve Bank which we started in when in government in 2004 can and should be pushed harder.

In March 2004, Labour introduced an important change: to enable the Bank to pursue a more active role in foreign exchange markets. This assisted the economy by tempering exchange rate volatility and moved New Zealand monetary management closer toward Australian practice.

We funded the Reserve Bank to intervene by buying or selling when it thought the currency was too high (or too low). So far the Bank's interventions have been modest and profitable.

We have an appetite for the Bank to push this harder. Yes, this carries some extra, albeit modest, risk for the Crown. But the potential benefits for exporters and therefore the economy (including the flow on benefits for the Crown) justify this. By increasing the risk for speculators that the Bank will catch them out, volatility will be reduced.

Another important change we would make would be to amend the Reserve Bank Act to broaden its objectives. The objectives of the Reserve Bank of Australia are the stability of the currency of Australia; the maintenance of full employment in Australia; and the economic prosperity and welfare of the people of Australia. In contrast our Reserve Bank is tasked solely with maintaining stability in the general level of prices.

However, changing the objectives Act will not, in itself, solve the problems we've faced. Changing the objectives is a necessary, but not sufficient part of reforming monetary policy.

While we are ruling out changing the target range (currently 1-3 percent on average over the medium term), the changes Labour will make to the objectives under section 8 of the Act, will require consequential changes to the Policy Targets Agreement.

In particular we would include a requirement to consider explicitly the effects of monetary policy on exports. In practice we believe that faced with rapid credit expansion, such as that

seen in recent years, this change would cause the bank, if permitted, to use prudential ratios, rather than rely solely on interest rates. This would be better for the export sector.

The role of prudential ratios is, in Labour's view, very important and needs clearer legislative authority.

Under Part V of the Reserve Bank Act the Reserve Bank sets capital requirements for banks. Currently the Bank can use prudential powers to support monetary policy **provided** that the powers are being used primarily for prudential purposes and that the proposed use of those powers will be effective for that purpose.

Existing capital requirements are only linked weakly to lending risk, and not at all to wider economic risks. Capital requirements that are better attuned to both these sorts of risk could be used to influence lending behaviour in a way that helps moderate inflation pressures.

The Labour Party in the 2008 select committee inquiry into the future monetary policy framework supported the use of prudential tools to respond to inflation given the implications of the rapid expansion in credit for risks in the household sector balance sheets and for the inflation outlook.

The National Party members on that inquiry included the Hon. Bill English. They said "The National Party rejects any suggestion the Reserve Bank could or should use its prudential supervision powers to achieve monetary policy objectives. Any change to the current objectives and method of prudential supervision would put New Zealand out of step with internationally accepted norms...."

I think National and Mr English have been and continue to be wrong on this.

The attitude of the Reserve Bank on using prudential policy to support monetary policy is changing. Dr Bollard and Felix Delbruck of the Reserve Bank authored a recent paper entitled "The Crisis and Monetary Policy: What we learned and where we are going". They have said that the Core Funding Ratio might be used to supplement the role of the OCR.

"...we believe that the new liquidity policy and in particular the Core Funding Ratio could usefully contribute to the monetary policy task by limiting the banks' ability to fuel credit growth using cheap and plentiful short-term wholesale funding during boom periods, as was the case from 2003 to 2007. In this respect, the Core Funding Ratio could potentially act as an automatic stabiliser and reduce the required hikes in the OCR during economic upturns. The role for a macro-oriented minimum capital requirement in promoting macro-financial stability (as opposed to individual bank resilience), and also assisting monetary policy, is less clear. The relationship between capital requirements and loan pricing is highly uncertain, particularly as the large lenders in New Zealand (as elsewhere) target capital holdings well in excess of current regulatory minima.

At best, these instruments could supplement the role of the OCR, but will not fundamentally alter it. Ideally, they would change the mix of monetary conditions and take some pressure off the exchange rate. Overall monetary conditions would still need to be set appropriately to keep inflation stable."

The core assets ratio can help reduce risk in our financial system by anchoring reserve assets in known risk classes with a minimum onshore deposit funding requirement. This will share the load borne by the OCR. It can also create stronger demand for domestic savings

In Labour we welcome the changes, flowing from Basel II, that have seen the Reserve Bank make greater use of prudential supervision tools to support Monetary Policy. But the positive effect of Basel II on monetary policy is almost accidental. The Reserve Bank Act needs to be clarified to ensure the Bank is able to use such tools primarily for the purpose of supporting Monetary Policy. This is a change Labour will make.

As indicated earlier we believe that faced with rapid credit expansion, such as that seen in recent years, these changes would cause the Reserve Bank to use prudential ratios, rather than rely solely on interest rates. This again would be better for the export sector. It would reduce the reliance of the Reserve Bank on interest rates (in itself a good outcome) while having a moderating effect on the exchange rate.

Basel III will also assist. The greater regulation of derivatives and off-balance sheet risk-taking by banks will also effectively limit the ability of international banks to increase credit in the manner of recent years.

What has Labour ruled out?

I will now indicate areas Labour will not change.

Labour will not undermine Independence

We will not undermine the independence of the Reserve Bank. We believe the bank should independently manage both financial stability and price stability. We believe its responsibilities should continue for both the bank and non-bank financial sectors. While we encourage co-operation with other jurisdictions, recent experiences of countries in Europe with the European Central Bank reinforce our view that we must never subsume NZ's rights to the interests of other economies.

Labour will not widen the inflation target range

Widening the target range would signal a more relaxed approach to inflation. Labour is not relaxed about inflation. We know the harm inflation does not only to the economy but to hardworking kiwis. This is why we've ruled out a wider target range.

Labour will not introduce mortgage interest levy

This idea was considered by the Reserve Bank and The Treasury in their Supplementary Stabilisation Instruments report. Whatever theoretical merits such a proposal has, Labour will not put a levy on already struggling homeowners.

Labour will not introduce a variable goods and services tax

Some have proposed that the Reserve Bank should have the power to vary the rate of GST to support monetary policy. The general idea is that over time the average rate of GST would not be altered, but in periods of high demand and high inflationary pressure it could be raised to dampen consumer demand, and lowered in periods of weakening demand. The Reserve Bank correctly observes that a variable rate of GST would have its own difficulties and costs. Changes in GST would normally require parliamentary approval, and if this requirement was removed additional transparency and accountability arrangements would be required. Business compliance costs would also be a worry. Following National's hike in GST, we will have one of the highest shares of consumption taxation in the OECD. Labour believes we tax basics enough anyway, and will not support a variable GST. It would hit families and those on fixed income hard, while those with high incomes have more flexibility to time their purchases to avoid the peaks and benefit from the troughs.

What else is Labour still considering?

Let me know turn to indicate those areas where we believe further consideration is warranted.

The world is giving greater recognition to the countercyclical role of macro-prudential policy. We are open to the idea that this might be expressly referred to in the Reserve Bank Act and are interested in the international debate around this issue.

We will also maintain interest in the ongoing efforts towards monetary reform through processes such as the G20, the Basel committee and the Bank of International Settlements.

In terms of other initiatives, further consideration of the effects of imposing a tax wedge on international borrowing is warranted

This option for reducing pressure on exchange rates that has been around for some time but has been gaining more international credibility recently. It would put an impost of additional taxation on international capital inflows or inbound foreign exchange transactions, to reduce the attractiveness of these flows.

The theory is that if a tax or 'wedge' was placed on returns that could be gained from the expansion of credit used to fund speculative investment in New Zealand, this would discourage such investment and therefore take pressure off the dollar.

A simple example is that when our interest rates have been higher than elsewhere, we have seen offshore investors (the apocryphal Japanese housewives and Belgian dentists) buying New Zealand debt to obtain the benefit of this interest rate gap. If there was a 2% tax on such transactions, our interest rates wouldn't be so attractive and demand for our dollar would decrease.

Such measures have been used in Chile for some time. On 20 October 2009 Brazil imposed a 2% tax on foreign purchases of equities and debt. This has recently been praised in The Economist. Similarly Gordon Brown called for the G20 to adopt such a tax as did Nobel Laureate in economics Joseph Stiglitz. New Zealand already has a relatively ineffective form of such a tax in the Non-resident withholding tax/Approved issuer levy mechanism.

The Reserve Bank argued strongly in favour of such a move in their submission to the 2008 FEC inquiry into Monetary Policy:

At present, most interest paid by New Zealanders to nonresidents is effectively exempt from New Zealand tax.

By contrast, interest paid to residents is fully taxed at the depositor's marginal personal tax rate. The situation is not quite as stark as this simple description suggests, because some foreign lenders will be liable for tax in their own country. However, after a cycle in which the ready availability of foreign capital has pushed the exchange rate to uncomfortable heights, it could be timely to review the tax treatment of interest paid to non-residents.

In particular, the current Approved Issuer Levy (AIL) system, under which issuers are able to replace non-resident withholding tax obligations with a payment equal to 2 percent of the interest payment on a loan, should be modified. We understand that over recent years an increasingly large share of the borrowing undertaken to finance spending and demand in New

*Zealand is undertaken using offshore structures that completely (and legally) avoid the obligation to pay even ALL. This both slightly lowers the cost of funds to borrowers (including banks) and also has the undesirable effect of discouraging the issuance of securities in New Zealand. **We recommend that all borrowing undertaken abroad to finance New Zealand business activity be brought back within the tax net.** This would tend to raise interest rates here slightly and would do so without boosting the exchange rate. **Had such a regime been in place in recent years, the peaks of the exchange rate might have been dampened a little.***

Accordingly Labour remains interested in further considering whether a tax on money coming in or interest paid on such money going out could support Monetary Policy. In particular we are interested in looking at whether a discretionary power to set a levy on overseas lending into New Zealand could be given to the Governor, to respond to situations such as that facing New Zealand in 2005, 2006, 2007 when increasing OCR was having a perverse effect.

More generally, I emphasise the importance for other economic settings to support both monetary policy and the export sector. Complimentary tax and savings policy to assist monetary policy by reducing our reliance on the interest rate tool is necessary if we are to rebalance the NZ economy towards our productive export sector. Today is not the day to enunciate Labour policy in those areas, but I strongly believe they are crucial to the outcome we desire.

We believe the package of changes I have outlined are needed and would make a difference. Allied with changes to our tax system, savings and investment, Labour would create the business environment exporters need to prosper. In turn all New Zealanders, and the services governments can only fund through a strong economy, would be better off.

That is what a good government can and should do to help you to achieve your potential.

If we collectively achieve this, New Zealanders will have more and better paid jobs, our current account deficit will decline, we will own more of our own country and have greater control of our own destiny.

Thank you for your time.

Ends