You can't always get what you want

Comments on monetary policy, the exchange rate, and the dairy boom

- **New Zealand is enjoying a truly huge commodity price boom, and the country will be better off as a result.**
- **It is normal for countries experiencing export price booms to have strong exchange rates.**
- **The high exchange rate is great for consumers.**
- **It does seem grossly unfair that non-dairy exporters must face a higher exchange rate, but the alternatives are even worse.**
- **The best approach is to reaffirm the commitment to the monetary policy framework, and to nurture productivity growth, not to vilify the Reserve Bank.**

New Zealand is enjoying one of its biggest commodity price booms since the Korean War. Back in the 1950s it was the price of wool that skyrocketed, and we soon found ourselves the third richest country in the world. This time it is the turn of dairy products, with prices more than doubling in the past year. New Zealand controls 40% of the world trade in dairy, so we are going to do very nicely out of this indeed.

With such a fantastic economic windfall, we have been absolutely mystified by the tone of economic debate recently. Anybody would think the country was about to enter a recession, not a boom! The high New Zealand dollar is causing consternation in the press and even in parliament. But we have seen precious little discussion on why the currency is rising, whether it is appropriate, or what the alternatives might be.

It is normal for countries that are doing well to experience higher exchange rates. It is a bit like the stock market – when a company does well, its share price rises. In the case of New Zealand, when our export products do well, our currency does well. And when our dominant export prices fall, the exchange rate falls.

And it's a good thing too. Our floating currency acts as a useful buffer, insulating the tiny New Zealand economy from the vagaries of world markets. During the Asian Crisis of 1998, the exchange rate fell dramatically and softened the blow for exporters. Now that commodity prices are lifting, the higher exchange rate is diffusing the benefits throughout the economy, by making imports cheaper.

Interest rates do have an effect, but they are not the only thing driving the exchange rate up. In fact, they are probably not even the most important thing.

It is time somebody advocated for the consumer

Every New Zealander is a consumer, and high exchange rates are great news for consumers. As an example, when the exchange rate fell in 2006, the price of petrol rocketed to $1.77 per litre. The world price of oil has now risen even higher, but here in New Zealand petrol is actually 20c cheaper. Pity those poor motorists in countries with weaker currencies than ours! The same goes for anything imported. All New Zealanders have just been given a big income boost thanks to the greater purchasing power of our strong currency.

But what about the exporters?

Of course, consumers' current good fortune is cold comfort to those exporters and import-competing firms who are facing the high dollar, but are not benefiting from strong world prices. There are business people who are seeing their years of sweat and tears evaporate in the puff of an exchange rate appreciation. It just doesn't seem fair.

Economic Research New Zealand +64 4 470 8250 bodonovan@westpac.co.nz Sydney +61 2 9284 8372 London +44 20 7621 7620
www.wib.westpac.co.nz

The trouble is, there can only be one exchange rate for the economy, and one interest rate. And right now both need to be higher. Of course we would all love it if there was some Nirvana where the dairy farmers could enjoy their boom, other exporters could have a low exchange rate, consumers could have cheap petrol, we could have low interest rates, *and* we could have low inflation. While we are at it, wouldn't it be lovely if the baby-boomers could keep their high house prices *and* have affordable homes for their kids? Well, get real! It is just not possible, economics is all about tough tradeoffs.

The exchange rate can hurt, but the alternatives are worse

The exchange rate has played a key role in stabilising inflation over the past two decades, working in tandem with the Reserve Bank. Imagine if the exchange rate had not risen this decade. Interest rates would have needed to be **much** higher to control inflation. The complaints about that would have been even louder than the current complaints about the exchange rate.

What if we had a lower exchange rate and lower interest rates – fixing the exchange rate or adopting the US dollar would have achieved that. But then adjustments to changes in the world economy would be much more painful for New Zealand. During the Asian Crisis, we would have endured much higher unemployment, bigger falls in house prices, more business closures, and an exodus of migrants offshore. In today's environment the problem would be chronic labour shortages and rampant inflation. That would impose huge costs on the non-dairy exporters and make them uncompetitive anyway. In fact, the situation would probably be a lot worse for non-dairy exporters, because they wouldn't even have the benefit of cheaper imported intermediate goods, such as oil. Meanwhile, Fonterra's payout to dairy farmers would be well over $8 per kilo, creating an even bigger and more disruptive shift of resources into dairy farming. The bonanza for domestic industries would be huge, but other export industries would be crowded out. The exchange rate is just facilitating what would have happened anyway. Relative price shocks always produce winners and losers, and that is just life.[1]

Beware those bearing cure-alls

One common suggestion is that we should "cut the OCR to prevent capital flowing into NZ and lower the exchange rate". Let's just check out the logic there. Suppose NZ was faced with the **opposite** set of circumstances to what currently prevail: let's pretend the world economy is contracting, commodity prices are collapsing, NZ's growth is imploding, house prices are going backwards, unemployment is soaring, and deflation has set in. Now, in that environment, would those same 'experts' be advocating interest rate **hikes**? Of course not. Perhaps, then, they would prefer to see the OCR cut during booms, and also cut during busts? Well, why not just move straight to a zero interest rate and then see what happens.

Another idea being touted is to give the Central Bank a holiday from its difficult task of targeting inflation. What would be the result? Hmmm, could it be higher inflation, higher inflation or higher inflation? Throw into the mix even stronger house price growth, an even bigger consumer spending binge and out of control inflation expectations. At a stroke, 20 years of hard work in dragging down and anchoring inflation expectations would be undone. We can guarantee that the long-run result would be a return to 1970s-style inflation and a long-term loss of competitiveness for NZ Inc.

We are already quite concerned about the upward drift in inflation since the 1990s. Since 1996 the PTA has been altered three times, and each change has involved an increase in the inflation target or a "loosening" of the definition of price stability. A rationale has been given for each change. But the frequency and direction of the changes have created the impression that a Government can raise the inflation target as a way of ensuring looser monetary policy during their three-year term of office. New Zealand's monetary policy regime appears less immune to the "political cycle" than many imagine. Financial markets as well as ordinary New Zealanders, therefore, are rationally factoring in the risk of future increases in (or the abandonment of) New Zealand's inflation target. Of course, this makes the Reserve Bank's job even harder.

What can be done

The first thing should be a resounding affirmation of the current monetary policy framework. Second, the Reserve Bank should send a strong signal about their unwavering resolve to prevent inflation. Targeting the midpoint, rather than the top-end, of the 1-3% inflation band would be another useful measure to help reduce inflation expectations.

The longer-run solution is to nurture the supply side of the economy and enhance productivity, so that the economy can grow faster without generating inflation pressure in the first place.[2]

[1] Singapore, to maintain its managed float, had their government surplus peak at 25% of GDP. In the past year, foreign reserves accumulation has amounted to 40% of GDP. Globalisation is causing all exchange rate regimes to come under pressure.

[2] For the list of areas of focus, see our Bulletin *"Taxing times (and mortgages)"*, 9 Feb 2007.

The real villain of the piece

Compared to the 1990s, the Reserve Bank's job has become tougher. That is because the speed limit for the economy has slowed in the 2000s. In recent years, most of New Zealand's growth has come from throwing more inputs into the production process. Productivity growth has been on a parlous slide.

NZ's multifactor productivity growth has slowed from 2.3% p.a. in the second half of the 1990's to 0.5% p.a. over 2001 – 2006. Between the same periods, New Zealand's potential growth rate (i.e., the rate at which the economy can grow without it proving inflationary) has dropped from close to 4% to sub-3%. If NZ had maintained the trend rate of productivity growth of the 1990s into the 2000s, nontradable inflation would now be closer to 2% than 4%. Now that is a big deal.

NZ's poor productivity performance not only spells bad news for the long-term improvement in NZ's living standards, it is also coming at the cost of higher interest rates and exchange rate now.

Give the Reserve Bank a chance to do its job

We are huge supporters of New Zealand's monetary policy regime. It was a world first when it was introduced in 1988, and it is now considered international best practice. The idea of an independent central bank pursuing an explicit inflation target has been copied by over 30 countries, including Australia, the UK, and the European Central Bank. The framework has served New Zealand well. **It should be being heavily endorsed, not questioned. Monetary policy is not the villain.**

Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250
Dominick Stephens, Economist, Ph: (64-4) 381 1414