
Supporting Paper A4

Why are New Zealand interest rates so persistently high by international standards?

Introduction

New Zealand interest rates are currently among the highest in the developed world – surpassed only by those in Iceland. Indeed, our real interest rates are higher than those in most emerging market economies as well. This paper, however, does not focus on current interest rates (examined in supporting paper A2), but on the more puzzling fact that New Zealand real interest rates have been persistently higher than those in most other countries over the entire period since the early 1990s. The gaps appear to be lower than they once were, but have shown little sign of disappearing. This paper outlines some of the issues relevant to understanding why New Zealand interest rates have remained high by international standards. There are, ultimately, no particularly compelling explanations, although some possible explanations can be shown not to be well grounded.

Some background

It is worth emphasising that, as other papers in this submission have highlighted, interest rates this decade have been relatively low by historical standards. As a simple illustration, in New Zealand, 90-day bank bill interest rates have averaged 6.4 percent this decade, down from 7.2 percent in the previous eight-year period.¹ New Zealand's inflation rate has been around 1 percent per annum higher this decade than it was in the previous period. That means

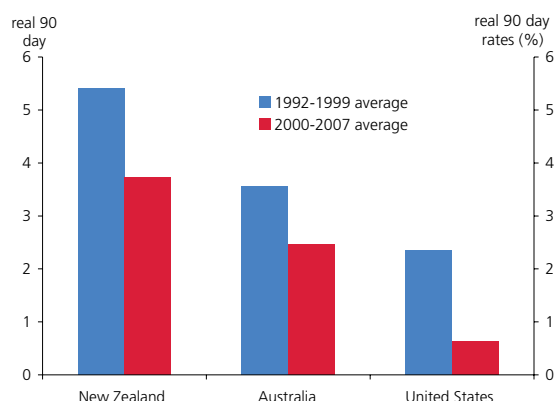
that once inflation is taken into account New Zealand's short-term real interest rates have been about 1.5 to 2 percent lower this decade than they were in the previous decade. In terms of cyclical peaks, the story is similar. Ninety-day rates peaked at a little over 10 percent in 1996 and 1998, while at present 90-day rates are around the highest level this decade at 8.5 percent.

In Australia, 90-day rates have been, on average, about half a percent lower this decade than they were the previous decade, and Australian's inflation rate has been about half a percent higher than it was in the 1990s. Around most of the developed world a similar story could be told: this decade has been surprising partly because of how much lower interest rates have been than they had been in the previous few decades.

But the focus of this paper is on cross-country comparisons. New Zealand real short-term interest rates have averaged around 1 percent higher than those in Australia this decade. Using different terms or different instruments produces slightly different results, but the underlying message is clear: real interest rates in New Zealand have remained persistently above those in Australia. Australian interest rates, in turn, have been persistently somewhat higher than those in the rest of the developed world.

¹ Dated from the start of 1992, by when the annual inflation rate had been cut to around 1 percent.

Figure 1
Real 90-day interest rates



Source: Reserve Bank of New Zealand, Datastream.

What is the role of the Reserve Bank?

The Reserve Bank sets the Official Cash Rate (OCR), and actual and expected changes in the OCR are a major influence on all other New Zealand dollar short to medium-term interest rates. In a mechanical sense, then, if short-term interest rates are persistently higher than those in other countries it is because the Bank put them there. However, the OCR is not set arbitrarily. Rather, the Bank looks at actual inflation outcomes, and at all the data on the outlook for inflation, before setting the OCR with the aim of keeping inflation comfortably inside the target range over the medium-term. If the Reserve Bank was consistently setting the OCR too high, we would expect over time to see inflation averaging towards the bottom end, or perhaps below the bottom, of the target range. In fact, inflation has consistently averaged in the upper half of successive target ranges – this decade, for example, inflation has averaged 2.6 percent. If monetary policy had been set consistently too tight, the solution would be easy. But there is no sign of that.

It has, at times, been argued that New Zealand's inflation target was too ambitious and that this might explain why New Zealand's interest rates have been persistently higher than those in other countries. In the early years of inflation targeting, our inflation target was lower than those in other countries, but as supporting paper A1 notes for the last five years our target (midpoint at 2 percent) has been firmly in the international mainstream. The most common developed country inflation target (actual or implicit) is around 2

percent. Our CPI is measured in much the same way as that in Australia, and there is no convincing reason why achieving an inflation target of around 2 percent should, over time, be any more demanding in New Zealand than it is in other developed countries.

In the 1990s, New Zealand interest rates were also unusually volatile, which may, at the margin, have resulted in the average level of rates being higher than otherwise. However, since 1999 the way the Reserve Bank implements monetary policy has been entirely internationally conventional and the size of the cyclical fluctuations in the OCR does not appear to have been unusually large either. As supporting paper A3 illustrates, the way we have used monetary policy in response to emerging data has tended to be quite similar to the way the Federal Reserve and the Reserve Bank of Australia have operated.

What might we have expected to see?

Economic theory, and simple common sense, would lead us to expect that in a world without material restrictions on the flow of capital the interest rates in otherwise similar countries would be quite similar. If they were not, funds would flow to the higher interest rate country to take advantage of the higher returns on offer. Those flows would tend to smooth out remaining material interest rate differences. This sort of interest rate parity need not hold in the short-term, but on average over time it should be a reasonable description of what we see. But it is not – or at least, it is not yet.

Similarities and differences

But how similar, or different, are countries? Three reasons are often advanced to explain why we might see persistent differences between the interest rates of developed market economies.

Over time, a country with a higher average (and expected) inflation rate should expect to have higher interest rates than other countries. But among developed countries, actual and expected inflation rates are all now quite similar. Even if one corrects, as best one can, for remaining inflation

differences, real interest rates in New Zealand have been persistently higher than those in other countries.

Riskier countries will generally have higher real interest rates than safer countries. Probably the best simple measures of credit risk are the sovereign credit ratings for various countries. But these do not seem to help explain much. The two main credit rating agencies rate New Zealand very highly – one gives us a AAA credit rating and the other a AA+. Both are very high ratings, and the difference in default risk between the two ratings is very small. Another way of looking at credit risk is to examine the interest rates at which the New Zealand Government or New Zealand banks can borrow in international markets (eg US markets in which our banks issue US dollar securities). Any margin over the rates paid by American banks, or those from other countries, is very small.

Smaller economies or those with less liquid markets might also expect to pay slightly higher interest rates over time. New Zealand is small and remote, and economic activity is a little more volatile than that in most developed countries. These might seem superficially obvious reasons why our interest rates should be persistently higher than those in, say the United States. But they do not help explain why our real interest rates would have been persistently higher than those in other small countries such as Switzerland, Singapore, Sweden, and Norway.

Standing back, it seems unlikely that factors such as credit risk, size and market liquidity help very much at all in explaining the persistent gap between our real interest rates and those in other developed countries. Apart from anything else, if these factors were (collectively) an important influence, we would expect to see New Zealand firms and household taking on less debt than those in other countries. In fact, of course, one of the well-recognised facts about New Zealand is that our households are highly indebted by international standards, and that the nation as a whole has been unusually willing to borrow, and raise equity capital, from abroad.

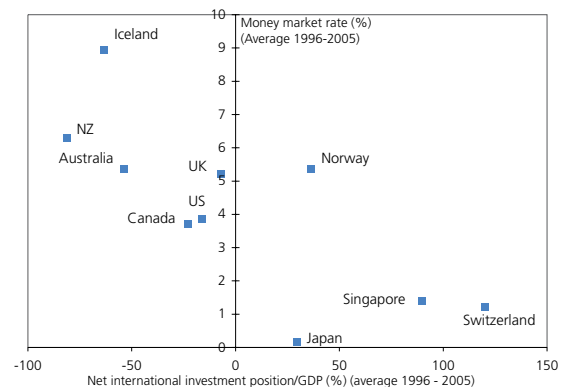
If monetary policy cannot explain why interest rates in New Zealand are persistently high, and size and market liquidity factors also cannot provide much help, where might we turn for an explanation?

One popular explanation is the large stock of net

foreign liabilities (debt and equity). At present, the net foreign liabilities of New Zealand (firms, households, and government) total around 90 percent of GDP. This number is much higher than those of most developed countries – the principal exceptions are Iceland and Hungary. And there is a clear correlation between the real interest rates a country faces, and that country's net investment position with the rest of the world. Countries such as Switzerland and Singapore, which have very large accumulated claims on the rest of the world, typically have low average domestic interest rates, while countries which have raised large amounts of debt and equity capital from the rest of the world (New Zealand, Iceland, and to a slightly lesser extent Australia) tend to have higher average domestic interest rates.

Capital does not flow across national borders (and across currencies) to the extent it does within countries and currency areas. Exchange rates are quite volatile and the added risk that this volatility imparts has tended to mean that capital displays a quite marked "home bias", more than can usually be easily explained by the actual additional risk. In other words, countries with lots of excess net savings end up with lower than average local interest rates because only some portion of the excess ends up flowing abroad to take advantage of the higher returns available offshore. By contrast, countries with a shortage of (net) savings end up with higher than average local interest rates to attract enough foreign capital to meet their demands. A premium price has to be paid to attract foreign savers away from the comforts and familiarity of home.

Figure 2
Interest rates and net international investment position



Source: IMF International Financial Statistics.

But the fact that this correlation exists between net international positions and local interest rates does not explain very much at all. In particular, it does nothing to explain what leads countries such as New Zealand to take on such large amounts of foreign capital in the first place. More specifically (and given that the Crown now has no net debt), what motivates New Zealand firms and households to take the actions that lead to this accumulation of foreign capital? And having accumulated the foreign liabilities (and New Zealand's, as a share of GDP, have not changed much in a decade), what makes higher interest rates sustainable here for prolonged periods? It might be reasonable to suppose that with New Zealand having run up such large amounts of foreign liabilities to the rest of the world, mostly denominated in New Zealand dollars, lenders might now be a little worried about the risk and be charging us an additional risk premium. But if that were the explanation, demand for new credit at prevailing New Zealand interest rates should have been rather subdued, and local savings might have shown signs of picking up. Instead, New Zealanders' willingness to borrow seems to have been as great as ever this decade.

There are some possible explanations that it makes sense to explore. Various researchers have noted that relatively young countries (ie those with relatively high birth rates and smaller shares of retired people, and with higher overall rates of population growth) have tended to have relatively high interest rates. There is some logic to this, because a young country needs to devote a larger share of its resources to building infrastructure (homes, schools, roads) than a country with a more static population.

Similarly, a country that is growing very rapidly on average might expect to see higher interest rates than usual. Rapid growth typically requires a lot of investment, and it would be quite reasonable for much of that investment to be financed not from increased domestic savings but from abroad. Indeed, if they were aware that such rapid growth was underway, it might be quite rational for New Zealanders to lower their savings to finance an increase in consumption in anticipation of the future higher incomes.

These factors may help a little, but only a little. Over long periods of time, New Zealand has not spent a larger share of its national income building houses than has the average OECD country. And although New Zealand has grown quite

rapidly over the last 15 years or so, much of that growth has largely relied on absorbing unemployed labour back into the workforce. The productivity picture (discussed in supporting paper A5) has not been particularly impressive, and over long periods the share of GDP devoted to total investment has been at or below the average level for OECD countries. Indeed, as supporting paper A5 suggests, the higher cost of capital that faces local firms, as a result of the higher New Zealand interest rates, may actually be holding back real investment by New Zealand firms.

And what of savings (the share of current income not consumed)? National savings in New Zealand have been relatively weak for a prolonged period (below the OECD average). This weakness has been particularly apparent in the household sector, which has for some years been consuming more than it is earning. New Zealand's economic fortunes have improved relative to those 20 years ago, but there is little in the data to explain why New Zealand households would be so much less willing to save, and so much more willing to borrow, at any particular interest rate, than households in similar countries such as Australia, Canada, the United Kingdom or the United States. Despite interest rates that have been materially and persistently higher than those in other similar countries, New Zealand households have accumulated debt (as a share of disposable income) as high as any in the world (and higher than most). Our households continue to accumulate debt rapidly.

We do not have particularly compelling explanations for why household savings appears so low. Right now, extraordinarily and unsustainably high house prices may be part of the story, fooling people into believing they have more real wealth and purchasing power than they actually have. But that story, even if true, does not explain the persistently low rate of savings. Some have argued that our welfare system may be more generously structured than those in other countries, which may reduce the need for savings. We are not experts in that area, although considering the whole range of welfare policies across OECD countries it does not seem likely to explain very much.

More recently, the OECD itself has raised the possibility that New Zealand's regime for taxing income on savings may be more punitive than those in most OECD countries. If so, that might help explain why our interest rates have

not proved more attractive to savers (and discouraging to borrowers). There have been recent changes in the tax regime, including the reduction in the company tax rate, and the reduction in the maximum final tax rate on income earned on assets held in Portfolio Investment Entities (PIEs). Over time, these measures may begin to alter overall national savings patterns. At very least, we believe that the taxation of income on capital, and the possible connection to the level of interest rates that prevails in New Zealand, may warrant further work.

Conclusion

Throughout the low inflation period (ie since the early 1990s) New Zealand real interest rates have remained persistently above those in the rest of the world. Ultimately, a compelling explanation for this phenomenon remains somewhat elusive. We are, however, reasonably confident that the explanation does not lie with the design or implementation of New Zealand's monetary policy regime. If anything, as other

papers in this submission have noted, official interest rates have probably been a little lower this decade than would, with the benefit of hindsight, have been desirable.

Foreign savers are, within limits, ready to finance New Zealand's appetite for credit, at the relatively high interest rates we appear to be willing to pay. However, the willingness of savers to shift their funds around the world is not limitless, and for that reason our high demand for credit results in persistently high local interest rates. Quite why New Zealanders are so ready to borrow, and reluctant to save, at interest rates that appear high to people almost anywhere else in the developed world, remains a puzzle. New Zealand's investment rates do not appear to be laying the foundations for unusually rapid future growth and households are already highly indebted. The tax treatment of savings may warrant further review. Looking ahead, it is still possible that the current extraordinary boom in house prices may be masking an underlying convergence in interest rates. But whether or not that is so will not be clear for a number of years.