

# Bringing it all together: where does this leave us, and where to from here?

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New Zealand's exchange rate has been the focus of much angst and debate recently. The fact that the average New Zealand income has failed to converge with the rest of the advanced world over the past few decades, has also attracted attention, and has been a subtext to the angst about the exchange rate. I agree that these are significant issues and those issues are indeed connected.

Angst about the exchange rate level, and perhaps the variability, crystallises in a view that if only monetary policy were run differently the problem would go away. But the hard won monetary policy lessons of the last quarter of a century demonstrate that we cannot generate sustainably more growth (in the real economy or in exports) by keeping monetary policy unjustifiably loose. And any attempt to do so would create future inflationary problems that would be costly (in terms of growth and employment) to resolve. So New Zealand's economic circumstances pose some serious challenges. Some things need to change. But the way that New Zealand's monetary policy is conducted - quite conventional by advanced country standards - is not one of those things.

To explore what might be the underlying cause of New Zealand's overvalued exchange rate let me start with an extremely stylised view of the economy, one which is easy for everybody to understand.

The economy I am thinking about is one which is at full employment and inflation is always on target so there is no need for monetary policy. Suppose however, that savings are insufficient to fund the investment needs of this economy (like New Zealand for the last 40 years). With access to global capital markets, this economy can fund its investment needs by borrowing from the rest of the world. The result is a capital account surplus. If foreign investors have any home bias in their investment decisions, then the more foreign savings that are demanded, the higher the interest rate the domestic economy needs to pay.

But because the overall balance of payments is by definition always zero, this capital account surplus requires a current account deficit. The exchange rate is the price that will yield a level of exports and imports to meet this requirement and therefore the exchange rate will be more appreciated. In this framework a lack of savings relative to investment needs yields a prediction of domestic interest rates higher than the global average, a high (appreciated) exchange rate and a persistent current account deficit.<sup>2</sup> This prediction matches the stylised features of the New Zealand economy over the past 40 years. In

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<sup>2</sup> The trained reader will recognise this description as version of the standard Keynesian IS-LM-BP model of the exchange rate that can be found in a standard economic text book such as Wickens, Michael (2008), *Macroeconomic Theory: A Dynamic General Equilibrium Approach*, Princeton University Press, Princeton.

passing it is worth noting that in this stylised story monetary policy played no role in generating such an outcome.

One of the worries often voiced is that New Zealand is suffering from a surge in unwanted capital inflows resulting in an overvalued exchange rate that in turn causes damage to exports and thus the economy's growth potential. While there may be temporary surges from time to time, what we would have expected to see – if this had been a persistent problem – is lower interest rates than in the rest of the world and a high exchange rate.

Of course, our economy is never at rest, so output can cycle around its fully employed potential and inflation can cycle around its target. These cyclical dynamics can generate volatility in the exchange rate. Moreover, given that exchange rates tend to move much faster than the prices of goods and services, any disturbance to the economy (whether trade related or not) can be reflected in the exchange rate overshooting its long term fair value.

Such overshooting opens up the possibility of a misallocation of resources between the traded and non-traded goods sectors. In addition, because the exchange rate is taking more than its share of the adjustment it will tend to be more volatile. Such volatility will add to the risks and uncertainties of investing in the tradables sector and thus reduce the incentives to invest.

While such a stylised framework provides a useful starting point, it cannot really be used to diagnose New Zealand's economic conditions and offer policy options because there are too many gaps. For example, this framework provides no reason why savings would remain low (relative to investment needs) over the long run. Moreover, the framework is not rich enough to give any insight into how the economy may be damaged from the constellation of low savings, high interest rates, and high exchange rates. For instance, story has no discussion of how a high exchange rate can allocate resources away from the tradables sector towards the non-tradable sector and what that means for growth and productivity.

The papers presented today fill many of the gaps left by my stylised framework and put forward ideas that help further our understanding of exchange rate issues in the New Zealand context. Some elements of the story are straightforward, and we can feel quite confident about them. But there are many things we do not know with the degree of certainty we would wish. Some of the puzzling issues of New Zealand's economic performance have perplexed analysts here and abroad for a long time.

Policy choices cannot wait until researchers have conclusively resolved all the puzzles. It is necessary for both the Reserve Bank and Treasury to provide advice even as we seek to increase our understanding. What we have set out today is a process of thoughts and judgements that lead authors to take the positions they hold. After the forum we will need to reflect carefully on how the insights of this analysis are incorporated into policy advice. I expect the arguments will be debated – in fact, I hope they will.

### **Overview of the day**

The paper presented by Michael Reddell looks back over history and takes a long term perspective of the exchange rate issue. He points to the puzzle that over a number of decades the real exchange rate has not matched New Zealand's relative productivity decline. This stylised feature of the data seems all the more puzzling given the far-reaching reforms New Zealand undertook in the late 1980s and early 1990s.

Reddell goes on to argue that not only has the exchange rate not adjusted as might have been expected, it has, if anything, been under upward pressure because of the persistent real interest rate differential. This differential reflects the fact that at any given interest rate (for example, the "world interest rate") there is a larger gap between desired investment

spending and the available national savings than is typical abroad. As in the simple thought experiment we started with, the underlying cause of the long term problem is the saving-investment imbalance.

While many people have worried about the lack of savings relative to other advanced countries, there has been relatively little thought to the investment side. Reddell is something of an exception to this. He argues it is the combination of New Zealand's modest savings and its quite large investment needs (associated with its relatively rapid population growth) that largely resolves the puzzle. The investment needed to provide infrastructure and housing in a fast-growing population, in a country with quite modest savings preferences, results in a need for a high level of capital inflows. As above, the pressures that generate these capital inflows yield higher interest rates and a higher average real exchange rate, which crowds out business investment that would have lifted New Zealand's productive capital and allowed progress in closing the income/productivity gaps.

The paper presented by Anne-Marie Brook starts from the current state of long-term imbalances in the New Zealand economy and examines what can be done going forward. The focus of this paper is on savings, with some seemingly radical ideas suggested.

Unless we start confronting difficult and radical ideas, we will be stuck with the same problems we have had for the past 40 years. Brook puts forward some policy options to boost private sector saving including tax changes, a range of different retirement income policy settings, and policies that affect the housing market.

One option considered is the introduction of tax-preferred saving vehicles to provide investors with options other than property. Specific options include: (i) reduce the tax rate on capital income, by extending the existing PIE regime; (ii) move towards a private save-as-you-go (SAYGO) pension system, which would involve pairing compulsory savings with means-testing of NZS; and (iii) strengthen the default policies that nudge individuals to save more (as KiwiSaver does). In addition, Brook considers a number of policies that would dampen house price inflation, which may help to boost private saving.

Turning to cyclical issues Willy Chetwin, Tim Ng and Daan Steenkamp examine real exchange rate volatility over the short term (periods up to one year) and the medium term (periods longer than one year). They find that the short-term volatility in New Zealand has been generally greater than in most other advanced countries. Significantly, they find that cyclical exchange rate volatility has been large and that we have had longer-lasting cycles when compared to other countries.

Such volatility opens the possibility of economic harm. Evidence of that harm is difficult to find, probably because it is always difficult to see what otherwise could have been under different circumstances. While we will never know what the counterfactual could have been, it seems implausible to think a less volatile exchange rate would have led to the same economic outcomes we have today.

To help mitigate this harm, Chetwin et al discuss various policy options that may be available. First, foreign exchange intervention might influence the short-term exchange rate volatility, but it is unlikely to reduce medium-term volatility. Second, improve the flexibility and efficiency of the economy and financial system to reduce the reactivity of the exchange rate to changing fundamentals. Third, subject to inflation expectations remaining anchored, use the scope within the flexible inflation targeting framework to trade off volatility in the exchange rate against volatility in inflation. Four, introduce, or use more extensively, other

non-monetary policy stabilisation measures, such as: fiscal policy, macro-prudential tools, and supplementary stabilisation instruments.<sup>3</sup>

Some of the proposed stabilisation measures might make a difference - and several are things I would support, whether or not they made any difference to the amplitude/length of the exchange rate cycle. For example, we should avoid the situation New Zealand found itself in from 2005 to 2008, where increases in government spending exacerbated the imbalances already apparent in an overheated economy. And reviewing microeconomic regulatory structures to help ensure that the economy can respond more flexibly to shocks, (for example, removing barriers to a responsive housing supply), are likely to make good sense. Avoiding policy-induced swings in migration is also likely to help (although many of the swings aren't directly policy-induced at all). Reducing the cyclicalities of domestic demand, the pressures that monetary policy has to lean against, is almost certainly desirable where possible - and is a case both our institutions have been making for decades. The use of macro-prudential tools, such as the new counter-cyclical capital buffer, may also help in this regard, although these instruments are more likely to provide better resilience in financial crises than do much to dampen upswings.

Enzo Cassino and David Oxley examine the relationship between exchange rate movements and the real economy. They survey a vast amount of theoretical and empirical literature for evidence on the relationship between fluctuations in the exchange rate and its impact on the economy. They find the evidence is often ambiguous. The relationship between changes in the exchange rate and adjustments in the economy does not follow any universal law, but depends on the nature of the shocks affecting the economy. Thus, while it is possible that any exchange rate overvaluation may have a negative impact on the economy, the existing empirical evidence does not allow them to reach a conclusive view.

Concerns about the exchange rate often give rise to questions about alternative regimes. The possible alternative regimes – floating, fixed or hybrid – are explored in the paper by Willy Chetwin and Anella Munro. They consider the trade-offs an economy faces when deciding on its combination of exchange rate, monetary policy and capital account policies.

We all may like to have independent monetary policy to control inflation, a stable and predictable exchange rate, and free access to global capital. Unfortunately, the famous “impossible trinity” of international finance tells us we can only have two of the three. Advanced economies outside the euro area have tended to choose open capital accounts, independent monetary policy for inflation control, and have foregone control over the exchange rate. New Zealand has made a similar choice. If New Zealand was to move in a different direction and pursue greater exchange rate control, that would imply less use of monetary policy for stabilising domestic conditions such as inflation and output, or a less-open capital account and probably require the holding of a larger stock of foreign currency reserves.

The paper presented by Richard Sullivan provides a history of New Zealand's monetary and exchange rate regimes since the break-up of the Bretton Woods system in the early 1970s. Sullivan focuses on the real exchange rate and how varying regimes affected its performance over the last 40 years. In large part, most exchange rate regimes New Zealand has tried – and we have tried many—have seen large real exchange rate variation. Sullivan

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<sup>3</sup> These are not new ideas. The Reserve Bank and Treasury looked into the issue in the joint Supplementary Stabilisation Instruments Report in 2006 - undertaken when domestic demand pressures appeared to be pushing the exchange rate to uncomfortable levels. The Reserve Bank also provided advice on this issue to the Finance and Expenditure Committee inquiry in 2007. Papers at the joint Treasury/Reserve Bank/VUW conference in 2011 touched on this issue.

finds that the mean, range, and variance of the real exchange rate prior to, and since the introduction of the flexible inflation targeting regime, are virtually identical. Moreover, he also finds that whatever exchange rate system is used, fluctuations in the real exchange rate have been driven by traditional economic drivers such as the terms of trade, relative cyclical economic performance and inflation outcomes.

### **Conclusion**

The papers presented in this forum cover a great deal of ground and confirm the widespread sense in the public debate that there are some exchange rate issues that matter for reversing New Zealand's poor long-term economic performance. Much of the public debate so far has centred on what monetary policy can do about an overvalued currency. But the papers presented today demonstrate that the issue is much bigger than monetary policy.

As much as we would like it otherwise, the overwhelming evidence is that monetary policy just cannot make a sustained difference to the real exchange rate. At the margin, monetary policy and foreign exchange rate intervention can perhaps take out the worst of the peaks and the troughs of the cycle in exchange rates.

There are non-monetary policies that could be used to reduce the long-run average of the real exchange rate. For example, fiscal policy could be geared towards increasing public savings (in the process building fiscal buffers and expanding NZSF contributions). Policy options to increase private savings include: taxing income from savings at a lower rate than from labour income; automatic enrolment of all workers into the KiwiSaver scheme; or even making KiwiSaver mandatory. Those responsible for such non-monetary policies might well give serious consideration to some of these policies. In addition, improving our understanding of New Zealand's desired savings and investments would be useful, especially since the interaction between our low savings and heavy investment in housing has undermined New Zealand's economic performance.

A number of non-monetary measures that might be used to moderate the exchange rate cycle have also been looked at over the course of the day, including: fiscal policy, macro-prudential policy, and various supplementary stabilisation instruments. Further work on the likely impact of these measures would be useful. Irrespective of whether they can change the real exchange rate much, some of these measures would be good to implement in their own right.