# Comments on the macroeconomic policy forum

*Val Koromzay, OECD*

I have found this forum to be immensely stimulating: both the presentations and the discussions have been very thought-provoking, and I would like to thank the Reserve Bank and The Treasury for inviting me to participate.

This conference has addressed two sets of issues, which I would summarise as follows:

(1) Is volatility in the New Zealand economy greater than it needs to be? If so, what can policy do to reduce it? Which policies? How?

(2) How worried should the New Zealand authorities be about the capital account surplus? What risks does it pose? What actions could be taken to reduce risks?

A third question which, to my mind, deserves to be included with the two above, was not a focus in this Conference. This is to ask what policies might do to reduce the costs associated with volatility (or indeed the costs of adjusting to a drying-up of capital inflows.) Essentially I have in mind policies (largely of a structural nature) that can assure a maximum of resilience to the real economy. But perhaps this is for another conference.

I won't seek, in these comments, to give my answers systematically to these questions, but rather to focus on selected issues that have come up during the discussions where there may still be something left to say.

Regarding the overall macro framework, it is important to stress, as others have done, that the New Zealand framework stands out in international comparison as a very good one indeed. In asking whether it could be adjusted to reduce volatility (in particular volatility of the exchange-rate) it is important to keep in mind that such adjustment could come at the expense of losing what New Zealand presently has. So caution is appropriate.

Specifically, as regards monetary policy, I would make three comments:

First, we had an interesting discussion, triggered by Stephen Grenville's paper, as to whether monetary policy has in fact become impotent (or at least much less potent) because, with globalization, monetary policy has lost control over the yield curve beyond the very short run.

This is clearly an issue to watch, but I would argue that the apparent failure of hikes in the overnight cash rate to push up rates farther out the yield curve is not a systemic change, but reflects rather the impact of a coincident global liquidity shock (one, to be sure, that is still not fully understood) that was simultaneously driving down long rates world-wide, and compressing risk margins as well. I would expect that, as this shock unwinds, the impact of the OCR on the yield curve in New Zealand will also normalize.

Second, I would argue that the main reason that inflation targeting is now in such high repute internationally is not just that it seems to be effective in anchoring inflation expectations, but that, in the process, it also dampens volatility in the real economy. This is true, in theory, in the case of demand shocks. I think it is also true, in practice if not in theory, in case of a broad range of supply shocks. The smooth absorption of the oil shock over the past two years is a case in point.

This consideration re-enforces, to my mind, the argument put by Willem Buiter that, among the tasks assigned to monetary policy, inflation control should have lexicographic priority over other tasks. If in general a strong anchor for inflation expectations is stabilizing for output, then there is clearly no exploitable trade-off between these two objectives. Of course, one cannot ask everything of monetary policy. If it is to stabilize both prices and (to a considerable extent) output it cannot be held accountable also for the composition of output as between tradables and non-tradables or, for that matter, housing construction and widget production.

This leads to my third point, intervention.

I am not sure why this issue has become one that generates almost ideological battles among proponents and opponents. Foreign-exchange intervention is hardly a mortal sin, but it has a bad reputation among many economists, perhaps because too much is claimed for it by its proponents. The evidence is that intervention,

particularly uncoordinated intervention (and with whom would the RBNZ coordinate?) is a weak and uncertain instrument at best. The risk is, however, that if a central bank puts intervention into its central tool kit, markets (and the business community) will start to hold the bank responsible for the exchange-rate – a charge which is neither desirable nor achievable. This would, at a minimum, greatly complicate the implementation of a clear, effective and credible communication strategy. Perhaps the present New Zealand approach, which allows intervention in principle, but only under a set of restrictions that make it very unlikely in practice, represents a reasonable balance in that it would not appear likely to allow market sentiment to start holding the bank accountable for exchange-rate outcomes.

What about Stephen Grenville's point that there seems to be a market failure, with insufficient arbitrage across the commodity cycle leading to excessive amplitude in the associated exchange-rate cycle? The trouble with such "regularities" in financial markets is that just when the evidence for them appears compelling, they tend to disappear (for obvious reasons). But if one wanted to exploit this regularity, I would see no great harm in assigning a role to public debt managers: a rule, for instance, that some fraction of new debt issues would be made in foreign currency if the real effective exchange-rate is, say, 10 per cent or more above its long term trend (with such positions unwound if it is 10 per cent below) would make money if Stephen is right, and not drag the Reserve Bank into complications it should rather avoid.

If I see little more that monetary policy can or should do to dampen the exchange-rate, what other policies could be considered? A few words about regulatory policies, and a few more about fiscal policy.

As regards financial supervision and regulation, my view is that the current New Zealand approach, which de-emphasizes formal rules in favour of requiring financial institutions to demonstrate clearly to the supervisors the adequacy of their own risk-management strategies and practices, is the right one and should be maintained. Of course financial supervision is an unending game; practices need to be constantly reviewed and revised to deal with financial innovation. Perhaps there are useful changes that could be made in New Zealand to further strengthen the resilience of the financial sector and reduce system risk. If it happened that such changes had the effect of reducing pro-cyclical swings in credit availability, this might be a good thing. But I would argue that supervision is too important a matter to subject it to secondary, so called "macro-financial" considerations. The supervision framework needs to be pretty single-mindedly dedicated to limiting financial system risks, while promoting financial development and innovation. From this perspective, adjusting prudential rules or norms to the state of the business cycle would be a bad idea. At the OECD we flirted with this concept in one of our reviews of an EU-member country: the idea was that maybe regulation could provide some kind of ersatz monetary policy in a situation where euro-area wide monetary policy was out of line with local requirements. The (winning) counter-argument was that such attempted fine-tuning would just push financial intermediation across the border. This argument may have somewhat less apparent force in New Zealand, but the risk is surely here as well that an overactive regulatory policy not clearly based on prudential principles would stifle financial development, and this would not be good for longer term growth.

What about fiscal policy? In principle, (or at least economic theory) a fiscal stance that leaned more strongly against fluctuations in the terms of trade (or, what is in New Zealand much the same thing, the business cycle) could limit the amplitude of the exchange-rate cycle. If markets recognized that a substantial part of the income gains associated with rising terms of trade would be captured by the budget (and conversely for terms-of-trade declines), market pressures or the exchange-rate should, in theory, be correspondingly decoupled from terms-of trade changes. This is the whole point, for example, of the Norwegian fiscal rule (all oil-revenues go into the pension fund, and only the notional returns on the fund go to the budget.). Since by now the fund is quite large relative to the annual flows into it (even at current oil prices) this rule, if credible, should provide fairly strong decoupling. The Chilean copper rule has a similar purpose. But in these two cases, the link between

the relevant commodity price and government revenues is direct, powerful and relatively easy to calculate.

For New Zealand, the problem is that while the impact of commodity prices is relatively important, it relates to a somewhat diffuse bundle, and the link to the budget is essentially through profit taxes. Further, these are themselves subject to lots of other shocks, and so even identifying a terms-of-trade component in the budget may be difficult.

Could fiscal policy nonetheless be made more strongly countercyclical? I offer three points for consideration:

(1) An activist, discretionary fiscal policy is not to be recommended. The international evidence suggests to me that this is little better, given the various lags, than a crap-shoot. And the political economy of this approach is awful. New Zealand has a world-class approach to fiscal responsibility that has yielded admirable results overall. Don't undermine it.

(2) Could the "automatic fiscal stabilizers" be strengthened? Big automatic stabilisers are arguably a good thing (only, arguably, because of political-economy considerations, on which more below.) But on this point I disagree with Willem Buiter. The only real way to buy bigger automatic stabilizers is to raise tax and spending shares in GDP; that is, to opt for bigger government. While the size of government is a basic social choice (and the empirical evidence linking size of government to overall economic performance is less clear-cut than popular debate suggests,) it would be bizarre to make decisions on something so fundamental and long lasting as size of government on the basis of something as ephemeral as short-run stabilisation properties. This point becomes even more compelling once it is recognized that political-economy constraints often mean that, beyond fairly narrow limits, 'cyclical' surpluses or deficits will in fact be neutralized through discretionary choice (by spending ministries when surpluses get too big; by the finance minister when deficits look too large.)

(3) All that said, it does seem to me that something could be done within New Zealand's present fiscal framework to reduce market uncertainty and perhaps moderate exchange-rate fluctuations. What I have in mind is an *ex ante* fiscal rule on how the budget will deal with revenue windfalls/shortfalls. As noted above, the link between terms-of-trade and budget revenues is not all that tight in New Zealand, but surely the correlation is positive. Budget projections based on "normal" terms of trade would thus tend to underestimate (respectively, overestimate) revenues in the face of terms-of-trade shocks. Telling the markets exactly how the associated revenue surprises would feed into spending, tax or debt-adjustment decisions could strengthen the stabilisation properties of the budget to some extent. (The more so if the *ex-ante* rule adopted emphasized debt draw down, or build-up).

I turn briefly (very briefly because I don't have any bright ideas) to the second theme of this conference: external vulnerability. Clearly, national saving in New Zealand is very low. National investment is not particularly high in international comparison (and surely not higher than it needs to be if New Zealand is to continue catching up to OECD's highest-income countries.)

The outcome is a large structural current-account deficit that is needed to close the gap between low domestic saving and moderate domestic investment. Is this a problem? I confess to belonging to the "consenting adults" school of thought on this issue. The public sector is not borrowing to consume; if the private sector chooses to finance its investments by borrowing rather than saving – well, nobody raises an eyebrow if an individual borrows 80% (or for that matter 95%) of the purchase price of a house; why should a country be different? But obviously this is too simple. There is still a powerful, if diminishing, Feldstein-Horioka effect; and markets are sensitive to it. Current-accounts remain, in the medium-term, powerful statistical indicators of country risk (and hence exchange-rate risk.) And it is probably too benign to assume, even for an advanced post-industrial economy like New Zealand, that it is exempt from a "brutal adjustment" scenario if conventional "sustainability indicators" are breached.

What to do about it?

(1) I would reject out of hand measures to make foreign credit more expensive (or more difficult to come by.) I simply cannot see any real medicinal value in, for example, putting a distortionary tax on foreign borrowing. It would simply stimulate unhealthy (because distorted) financial innovation.

(2) Should the fiscal stance be tighter than otherwise (higher public saving) to compensate for low private saving? Analytically, the answer is almost surely yes. (Ricardian equivalence is nowhere 100%, though it is non-negligible in most countries except, interestingly, the United States.) But here one runs into political economy. How large a surplus can a democratic political system sustain on an argument as abstract as "we need it to maintain national saving because you (the voters) aren't saving enough"? The US experience from the Clinton/Bush transition is telling: if one administration tries to save, it provides its successor with the wonderful opportunity to win friends by cutting taxes!

(3) The question then becomes, what can be done on the tax side to encourage more private saving? I wish I had a better answer here. The international evidence is that tax rules can powerfully influence the composition of private savings, but not the aggregate (very much.) Of course, the international evidence doesn't cover many (indeed any) radical changes in the tax regime.

    For instance, moving the tax system entirely from an income base to a consumption base (e.g. by exemption of all income placed in investment vehicles from income taxation while raising the VAT to be revenue-neutral *ex ante*) should logically, and even analytically, improve both private saving and overall tax efficiency. But the politics of shifting the burden of taxation from income to consumption seem to be extremely difficult. Indeed, it is striking that the new government in Canada opted to anchor its successful electoral campaign on cutting the consumption tax – economic efficiency be damned! As I noted above, half-way measures, such as increasing the tax value of certain instruments have almost no impact on aggregate private saving.

(4) Finally, to end this presentation on a more positive note, some things could surely be done to shift the national balance away from housing investment towards business investment. This would, *inter alia*, generate more future income to service foreign debt. As in almost all OECD countries, tax preferences provided to home-purchase exist in New Zealand but serve no obvious social purpose insofar as they basically generate rents to current owners and are rapidly "capitalized out" of the market through higher land prices, thus leaving new buyers no better off. Reducing such incentives, and indeed increasing property taxes, would both be efficiency-enhancing. The political-economy of such moves is daunting but not insuperable: some OECD countries have managed to reduce tax distortions in favour of housing by phasing-in such changes over a fairly long horizon and 'grandfathering' existing rents by making new tax laws apply only to new purchases. But I have no illusions: the required changes are not electoral winners and would require extra-ordinary political leadership.

To conclude, just one word on how New Zealand needs to think about minimizing the potential costs of high volatility in the exchange-rate. This requires micro-economic policies that maximize flexibility on product and labour markets. To the extent that New Zealand is more exposed to macro-economic volatility than most other OECD countries, New Zealand cannot afford regulations and institutions that generate only "OECD average" results. Substantially more labour market flexibility than the "OECD average," and stronger than average competition on product markets is required. This is the situation at present, and this differential needs to be maintained.

# Comments on the macroeconomic policy forum

*Steven Dunaway, IMF*

With the papers presented, the discussants' remarks, and the participants' questions and comments, this conference has certainly done an excellent job of addressing its key issue: "whether external balance and smaller swings in the exchange-rate can be achieved while maintaining and/or enhancing overall prospects." It is a rather difficult task to try to find something very insightful that will meaningfully add to the discussion. That being the case, I will just focus on some of the more practical aspects of the issue, reflecting on the discussion today.

I think that Governor Bollard in his opening remarks framed the key question well when he asked whether New Zealand's recent experience was a unique set of circumstances. Recent experience with very loose monetary policy in the major developed economies of the world (the United States, Euro Area, and Japan) does not seem likely to be repeated in the near future (although a needed fiscal correction in the United States could produce somewhat similar conditions with a looser monetary policy offsetting the effects of a fiscal contraction; but the prospects of that happening in the near term are probably pretty slim). The savings glut in Asia that has fed world liquidity and held world interest rates down also is unlikely to last. To a significant extent it has been fueled by undervalued exchange-rates, and adjustments in these rates will be forced eventually one way or the other. Hopefully this will happen in a constructive way, with increased exchange-rate flexibility in the region, which is an objective we at the IMF are working hard to achieve.

Moreover, the discussion today has focused on developments in New Zealand as being largely driven by domestic demand, especially through the housing market. However, there probably was a significant "push" element behind the large capital inflows New Zealand has received. With interest rates higher in New Zealand and growing worldwide recognition of the basic soundness of New Zealand's economy and macroeconomic policy management, there was probably an element of a shift in portfolio preferences in favour of New Zealand dollar assets. This was probably a one-off factor that drove capital flows into New Zealand.

Thus, at the end of the day, there is a lot to lead you to believe that the economic situation that New Zealand has recently experienced is, to a significant degree, a classic case of a small economy out of synch with cyclical developments in the rest of the world. Complicating the situation of course was the set of unique circumstances in the world economy. Nonetheless, it is good to ask the question whether the situation represents something else and, if this is indeed the case, to explore how similar situations in the future should be dealt with. I have been involved with New Zealand on and off over the last fifteen years, and one of things that I have always admired is the unrelenting push by this country's macroeconomic policymakers to ensure that they are on the cutting edge of policy formulation and implementation. This conference epitomizes why they truly are.

One development that may have not received enough attention today is how macroeconomic policy implementation, particularly the way monetary policy has been implemented, appears to have changed the behaviour of economic agents, especially households, and affected the transmission of monetary policy changes. Stephen Grenville referred a bit to this in his presentation. Household behaviour has been influence by the way monetary policy changes have been implemented in steps. As a result, households have demonstrated flexibility by moving along the yield curve and positioning themselves to mitigate the effects of rising interest rates by shifting to longer-term fixed mortgages when short-term interest rates were rising. Firms too have behaved similarly and used available market instruments to hedge interest rate risk. They also have adapted well to an environment of increased exchange-rate variability by hedging their exchange-rate risk for longer periods into the future. As a result, the influence of monetary policy on the economy is diluted and delayed. But these methods only delay, not avoid, the impact of monetary policy changes. As a result, interest rate movements tend to be larger and when hedging cover begins to roll off the impact on the economy is more sudden and stronger. The lesson for policymakers is that they will have to be nimble; prepared to

quickly shift gears from a tightening to a loosening stance when conditions dictate.

In these changed circumstances, it is understandable to look at other policies to help support monetary policy. But in doing so, you always have to ask what is the cost of doing this and is it really feasible, particularly in a political economy sense. In the many instances discussed today of fiscal policy initiatives that could support monetary policy, the key element boils down to how such discretion in fiscal policy might be used to the greatest benefit. That is, how can it be made more independent and free of political decisions. While such considerations are attractive, at the end of the day, political reality intrudes. Will political authorities give up control over some aspects of fiscal policy? To a large extent, perhaps we should be grateful that the political authorities in many countries have provided monetary policy independence, and we should not push our luck. In the end, maybe the best that can be hoped for is that fiscal policy is implemented in a relatively stable and predictable fashion, providing a useful environment in which to operate monetary policy.

If this is the case, then the best thing to do might be to focus on broad fiscal policy rules, perhaps some countercyclical rule of the type that Klaus Schmidt-Hebbel has talked about. Such rules should basically be designed to ground fiscal policy appropriately over the medium term and help it to complement monetary policy actions in the short term. However, it may be possible to achieve this result without a formal rule. The approach to budgetary targeting used by Canada could provide an example. It was described by the opposition party in Canada as the Minister of Finance "hiding resources from his spendthrift friends in his own party." What it boiled down to in practical terms was a prudent, conservative approach to budgeting that tended to underpredict revenue and run surpluses in good times. It involved relatively conservative economic projections being matched to a careful assessment of the "long-term" relationship between revenue and income. And a somewhat similar prudent, conservative approach in budget formulation has been followed in New Zealand, with the same basic results. So, perhaps a formal rule is not needed. Of its own accord, a rational, medium-term oriented fiscal policy can still produce results consistent with aiding monetary policy in stabilizing economic activity in the short term. In the end, I guess, what is always needed is a solid framework for formulating fiscal policy, but it is essential to have a prudent fiscal authority implementing that policy, which fortunately New Zealand has been blessed with.

Finally, let me note that financial regulation and supervision can also play an important role, especially in helping to avoid problems or at least limit excesses. I know this type of use of regulatory authority tends to be frowned on by some in the profession. They suggest that it is not appropriate to use regulatory authority in an asymmetric way—that is, to tighten rules during economic upturns to avoid excesses, but not to loosen them during a downward phase of the business cycle to try to boost the economy, since these rules are intended for prudential reasons. Again, I think practical considerations should win out in this debate. Regulatory guidance can and has been successfully used to prevent excesses in the financial sector during economic expansions. The best example of this is in the United States during the last business cycle. Throughout the end of the 1990s, the Federal Reserve and the Office of the Comptroller of the Currency frequently issued guidance letters to the commercial banks warning them about properly factoring in prospective economic conditions into their lending standards and practices. The result was that during the recession of 2000-01, no major financial institution in the United States encountered substantial financial difficulties, despite significant losses by some institutions owing to the major corporate frauds that occurred. This was a sharp contrast with the situation during the recession in the early 1990s when a few major institutions encountered difficulties which potentially threatened the US banking system.

# Comments on the macroeconomic policy forum

*John McDermott, Victoria University of Wellington*

Thank you for the opportunity to speak today. My understanding is that the panel's function is to offer its reflections on today presentations. There was a vast amount of material presented today; enough for policymakers to reflect on well after our overseas guests have departed. It would be impossible to tackle it all, so instead I will focus on four issues: the importance of commodity prices, foreign exchange intervention, prudential instruments, and the current account.

We tell everybody when they arrive that New Zealand is a big farm and it is a nice place to visit. However, in his paper Willem Buiter suggests that we should be suspicious about the overall importance of the primary sector for economic performance since agriculture makes up only a small proportion of production. Despite his suspicion about the importance of the farming sector I hope he agrees that it is a nice place to visit.

Looking at the size of the primary sector is an inadequate means to determine the sectors relative importance. First of all a large portion of New Zealand manufacturing is based on food processing. Second and more importantly, what matters is how shocks to the primary sector, typically changes to commodity prices, are transmitted to the real economy. The issue of whether commodity prices are important is an empirical one.

Borkin (2006) has found that the terms of trade impacts significantly on economic growth in New Zealand. Specifically, he finds that economic growth is positively related to the growth rate of export prices (but not import price growth) and is negatively related to the volatility of import prices (but not the volatility of export prices). The transmission mechanism from terms of trade shocks to the macroeconomy appears strong in New Zealand because of its economic structure. Unlike most advanced countries, Cashin and McDermott (2003) found that New Zealand importables and nontradables are complements implying that, in response to adverse movements to the terms of trade, the household sector cannot substitute away from relatively expensive importables. Hence, the real income effect of commodity price and terms of trade changes are larger than would otherwise be the case.

Steven Grenville also discounted the importance of commodity prices by noting that when commodity prices move, they move a long way but the movements are temporary. However, the empirical evidence on the persistence of commodity price movement does not support this conclusion. Formal econometric evidence suggests there is unit root in commodity prices implying that the impacts of commodity prices are permanent. At the very least the half-life of any shock is very long, in the order of years rather than months.[1]

In addressing the issues of whether intervening in the foreign exchange market is a sensible and useful policy it is important to consider the structure of the New Zealand economy. New Zealand is a small open economy whose commodity exports make up around 50 per cent of its exports of goods and services, so there seems good reason to suppose that commodity prices would be an important determinant of the exchange rate. Again this is an empirical issue.

Chen and Rogoff (2003) have reported strong evidence that the New Zealand dollar, along with the Australian dollar and Canada dollar, is a commodity currency. That is, commodity prices have a strong and stable influence over the real exchange rate. The long swings observable in the real exchange rate are fundamentally driven by commodity prices and there seems no room for profitable foreign exchange intervention.

However, it is possible that the exchange rate overshoots its fundamental value from time to time and that the Reserve Bank could intervene to mitigate this overshooting. But is this a sensible policy objective? What market failure would the Reserve Bank resolve?

Even if we consider the exchange rate excessively volatile, exporters and importers can buy financial instruments to

1 For example see Cashin and McDermott (2002), Cashin, Liang, and McDermott (2000), and Cashin, McDermott, and Scott (2002).

hedge this currency risk. Unfortunately, the currency cycle is too long relative to the duration of options that are typically traded. Financial markets will provide long duration options, but because they are traded rarely the pricing often deviates from the theoretical pricing from a standard Black-Scholes formula. The deviations favour the sellers of the options who believe they need to be compensated for the illiquidity of the market. This liquidity effect reduces the demand for long-term options even more than would otherwise be the case. If this is the identifiable market failure then the Reserve Bank could enter the market be selling long-duration options at the theoretical fair price, thus making a market and making an accounting profit at the same time.

Another risk with foreign exchange intervention is what I refer to as the "Dominion Post" risk. Suppose the Reserve Bank intervened in the foreign exchange market a little bit too early and initially started to lose money. There would be a tremendous amount of interest from the media regarding the financial losses, creating a huge distraction from the objectives of monetary and prudential policy. The fact that it may make a profit over the cycle would be lost in the furore.

On balance, the exchange rate, to a large degree, moves with the economic fundamentals suggesting there are little or no market failures and thus nothing to be gained from foreign exchange intervention. Moreover, the associated credibility risk with intervention would more than outweigh any potential benefits.

Grenville suggests that it may be useful to introduce some prudential instruments as a complement to monetary policy. One problem with such an approach is that trying to control the macroeconomy via the credit channel may prove more difficult than anticipated since we have no information on the likely responses of the private sector to direct controls. Another problem is that the distortions introduced by using direct controls may be worse than the problem they are trying to cure.

One modest but very good idea suggested by Grenville was that of improving data collection. We do not know the purpose of most loans secured using a house. While the majority would be for the purchase of a house which the owner will live in, a significant proportion are used to buy investment property or as start-up capital for small businesses. Requiring banks to collect such information and report it publicly could prove to be hugely beneficial in developing our understanding of the credit movements in this economy.

The current account balance is the final issue I want to mention. Stephen Grenville addressed the issue by noting that it is a safety valve, as was also suggested from the floor. When there is pressure on domestic resources you can ease this pressure by importing additional resources. Examining the cyclical nature of New Zealand's current account I think it has been used in that fashion.

Access to global capital markets also allows New Zealanders to shift consumption through time in more optimal ways. There is some evidence that New Zealand does actually consumption smooth through many of its cycles.[2] However, during the current expansion phase of the business cycle we have not been consumption smoothing. If we had been the current account deficit would not have grown the way it did.

Nevertheless, I do not think that was necessarily a bad outcome. A rational response from the private sector seeing a rapidly appreciating exchange rate that by most measures was overvalued would be to bring forward their purchases of imported durables, and in particular Japanese second hand cars. In effect Japan was selling cars to New Zealand cheaply and offering very attractive finance at the same time. Now that the exchange rate cycle has turned we should expect to see the imports of durable goods being reduced and the early signs are that this is exactly what is happening. Economic forces are working as they should and this suggests that direct intervention would not improve the situation.

Another issue with regard to the current account is the ability and willingness to repay. At some point it will be necessary to repay the loans used to finance the current account deficit. If that deficit financing was used to fund investment and if that investment was sensible then you would have the ability to repay the loans. However, if the

[2] For example see Kim, Hall and Buckle, (2006).

deficit financing was used for consumption then that is a much more troubling development.

Examining the structure of the current account we see that some of it went to consumption and some of it went to investment. The investment part I have no problem with since it will add to the New Zealand capital stock, thus improving our potential growth rate and increasing our ability to repay the loans. I am even comfortable with the increase in consumption because I think much of it went into the purchase of durables which can be viewed as an investment in a future stream of consumption services. Moreover, for the reasons stated above this type of spending will naturally slowdown and the exchange rate has started to depreciate.

Reflecting on all issues discussed at the forum, there was no obvious missing instrument that would deliver a home run for economic policy. However, a consensus did emerge that there are marginal improvements to be had and that we can improve the overall system and I think that that is a sensible way to look at the issue. Examining our own history and the evolution of policy tools in New Zealand shows that policy can always be improved. For example, the introduction of the Official Cash Rate (OCR) system was an improvement on the previous regime which used the Monetary Conditions Index (MCI) to implement monetary policy. It is these types of improvements that we can make and that we should be searching for. Possibly they are not as exciting because they are more incremental in their nature, but improving the implementation and technical aspects of monetary policy is as important as any grand scheme and probably a more fruitful avenue for research and policy making.

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