

Alan Bollard: Can New Zealand expect to carry out independent monetary policy?

Excerpt from an address by Dr Alan Bollard, Governor of the Reserve Bank of New Zealand, to the Association of Superannuation Funds of New Zealand, Auckland, 13 July 2006.

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Reserve Bank Governor Alan Bollard says New Zealand can still expect to carry out its own independent monetary policy effectively, even though it occasionally has had to work against strong global crosswinds that can delay its impact. In a speech today to the Association of Superannuation Funds of New Zealand, Dr Bollard said New Zealand had just been through such a period, but now monetary policies are more aligned globally, enhancing the effectiveness of New Zealand's policy. The following is an excerpt from that address.

"Since 1999 New Zealand has been through a longer growth phase than any since the 1960s/1970s. It has been a stronger period of growth than in Australia, the US or the UK. This growth has partly been driven by strong commodity prices and population changes, but partly also by strong household spending, fuelled by growth in house prices, and a readiness to take on increasing amounts of debt.

"The Reserve Bank did not feel it could just ignore this build-up in asset prices. To us it signalled growing pressures through the economy. New Zealanders, feeling wealthier from owning more valuable houses, were actively looking for ways to spend that wealth.

"As far back as 2004 the Reserve Bank was forecasting growing inflation, correctly as it has turned out (though that was not always the view of market commentators). Consequently in January 2004 it started tightening policy, taking the first step in what proved to be nine tightenings.

"This tightening cycle took place against an unusual international backdrop, and one that proved to be more than usually influential.

"Back at the turn of the millennium, US interest rates were for a while very close to New Zealand's. Then came the 9/11 crisis, the end of the 'tech boom' and also some unusual deflationary influences.

"As the economies of China and other emerging market economies got more connected to the developed world, we saw a flow of very cheap manufactured goods that helped depress prices; a flow of labour into the services sector; and very cheap capital produced by East Asian saving. The crash in technology-based equities resulted in a collapse in investment in the US and Europe and opened up significant excess capacity.

"For the first time for many years the central banks of the big developed countries were faced with a prospect of deflation and capital inflows. They reacted strongly by cutting interest rates radically. The US Federal Reserve, for example, slashed rates from 6.5 per cent (the New Zealand rate) in 2001 to only 1 per cent in 2003. (In New Zealand we were much more cautious, only cutting rates to 5 per cent.)

"New Zealand has never in recent years had to run monetary policy in an environment where the G-3 economies - the US, Japan and Europe - were running such loose monetary policy of their own.

"The problem was exacerbated because the New Zealand business cycle was running well ahead of those in the big economies: while they were still worried about deflation, we could see inflation pressures mounting. Demand was very strong in many domestic industries, capacity utilisation was reaching record high levels and skill shortages were becoming acute.

"New Zealand started raising rates in January 2004, just ahead of the US Federal Reserve's long climb back towards neutral real rates. Initially as we put up the Official Cash Rate, New Zealand short-term market rates rose as expected, but the long end remained stubbornly low, anchored to US rates expectations.

"We were experiencing another outcome of financial globalisation: long-term rates in New Zealand have over the last decade started to become very closely correlated with US long rates.

"In New Zealand the floating mortgage rate rose quickly. Households increasingly switched to cheaper fixed-rate mortgages. The banks could readily provide these due to the cheap New Zealand dollar funding offered by overseas investors through instruments such as Uridashis and Eurokiwis. In 2003,

less than 60 per cent of all mortgages were fixed, by 2006 it was more than 80 per cent. Competition between the mortgage lenders also acted to keep fixed rates low as bank margins were reduced to historically low levels.

"The Reserve Bank kept pushing up the Official Cash Rate to slow demand. The effective mortgage rate, the main transmission mechanism for monetary policy in New Zealand, rose, but to only half the extent of the Official Cash Rate increase. Monetary policy was working, but more slowly than the Reserve Bank would have liked.

"We could see that the full effects would eventually flow through on to mortgages, but in the meantime homeowners seemed to be borrowing on the expectation that rates would stay low. In doing so, households were skewing their balance sheets further towards low-yielding housing assets. Holdings of financial assets now look very low compared to what we see in other countries.

"Overall gearing was not substantially increased. Households were apparently not worried about their greater indebtedness, about low rental returns, or about saving all their eggs in one basket.

"By 2005 New Zealand's normal short-term interest rates were looking high by OECD standards (though not, despite some media confusion, the highest). The difference in yields was attractive to some investors, and that is one of the factors that contributed to the persistently strong New Zealand dollar. (Another key reason, we should not forget, was the strong terms of trade.)

"This was certainly a factor weighing on the Reserve Bank's mind over the last couple of years, and a reason why tightening took place gradually and moderately. (As an aside, although some export industries came under significant pressure as the exchange rate rose, the sector as a whole appears to have managed the strong Kiwi dollar better than in previous cycles.)

"The beginning of 2006 marked something of a turning point. The Reserve Bank finished its tightening cycle. New Zealand's terms of trade started to soften. Other OECD monetary policies started to catch up. And the trade weighted index fell by around 18 per cent between December 2005 and June 2006. At the same time the 'pipeline effects' of the Official Cash Rate on fixed mortgages are continuing to come through.

"This marks a rebalancing of economic growth from domestic sector-driven to export-driven. In this stage of the cycle our monetary policy has become a more effective brake on domestic spending.

"Even during the best of times, monetary policy affects activity and inflation with a significant lag. However, as we look back on 2004/05, we see a 'spongier' monetary policy than would be the case normally. Applying the brake took longer to slow things down. This is similar to a two-year period in the mid-90s, when our domestic/international interest rate differential was quite marked.

"Clearly, this could occur again at some stage in the future. It becomes more of a problem when New Zealand's business cycle is significantly out of step with the OECD's, or when the latter have focused their monetary policy on a quite different issue. Arguably, we have also had times at the opposite end of the cycle, when it has been harder than we might have wished to stimulate consumption.

"The Reserve Bank and the Treasury now have a work programme focused on whether there are ways to reduce the likelihood of finding our economy out of sync again; or on handling it differently if we do.

"What is clear is that in a globalised world most of the Government's economic policies, including fiscal, industry and immigration policies, are all constrained by other countries' policies and by international pressures on them. With financial markets so interconnected, any small country's domestic monetary policy also now needs to be seen in an international setting.

"Nevertheless, there is no question that we can run an independent monetary policy. We have control of our ship. If global winds are not behind us or our economy is out of sync with influential economies, then our progress becomes more difficult, and things can get uncomfortable. We may have to modify our chosen course.

"But with major economies now raising their interest rates, global conditions are becoming aligned to containing inflation. In these conditions, New Zealand monetary policy is increasingly effective. Indeed in some respects we are in a more comfortable position than some other countries, having already raised interest rates.

"In the meantime, we are starting to see some other countries, especially small open commodity economies, realising this too as they start to face the same pressures. They have been following the New Zealand experience with interest."