Transcript

Inquiry into Future Monetary Policy Framework

Finance and Expenditure Committee

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Submission 71

Smith	Mr Keith Rankin, submission number 71. Keith, can you hear me okay?
Rankin	Yes, I can hear you.
Smith	Excellent. Keith, welcome to the Finance and Expenditure Committee. Sorry to hold you up a few minutes. We are obviously under real time pressure. If you could focus on the particular aspects of your presentation that you would like us to focus on, please do that and leave us a little time to question you. So fire away.
Rankin	Thank you, Lockwood. The main points in my presentation—I guess there are a number of them, but the first one is to make the distinction between inflationary pressure and inflation. Inflationary pressure itself does not necessarily lead to inflation, and it can actually have beneficial effects. For productivity to improve, inflationary pressures will often assist by creating the incentives that lead to improvements on the supply side of the economy that will alleviate long-running inflationary pressures. So pressures on their own are not necessarily a problem. Second point is the distinction between acceptable and unacceptable inflation. The economics textbooks, they emphasise that inflation is a process, and so therefore unacceptable inflation is an ongoing process of price increases of more than, say, 3 percent. So whenever prices exceed 3 percent for even a year or two does not necessarily make it a process. On account of that, the best way of treating an episode is not necessarily to apply a cure. Sometimes it is best to simply wait for that episode to self-correct. The next thing I would like to note is just about the distinction between cost inflation and demand inflation, and the actions of the Reserve Bank quite distinctly add to the cost of the economy, and the way that interest rates add to costs, some are more overt and some, if you like, are more covert. The cost impacts on a capitalist economy of high interest rates are significant. So what we are actually seeing with monetary policy is cost-inflationary pressures opposed to attempts to reduce demand, which will hopefully reduce inflationary pressures, but it is a race between aggravating inflation by raising costs and relieving inflation by reducing demand. It seems to me that the benefits we get from doing that are often considerably outweighed by the costs of such a process. Finally, in terms of effective monetary policy so far, I guess there are two more main things I will comment on. It certainly seems clear from the evidence that when we started to tighten—going back to 2002—that it has been completely ineffective in that non-tradable inflation has sat at about 4 percent for the whole time. So policy has clearly been ineffective. And even if we look right back to the 1980s, the only way we can judge the effectiveness of monetary policy is by having a clear counterfactual, which is what we believe would have happened had that policy not been applied.

The best way to derive such a counterfactual is by looking at other countries, where our inflation policies were not adopted. Examples in the 1990s would include Australia and the United States. They have similar inflation rates to us but without the types of policies that we applied. Likewise, in more recent years, other countries have had lower inflation than we have had while have not been tightening or raising interest rates the way that we have done. So if we had not raised interest rates as much as we had done, it is quite likely that our inflation would have been lower rather than higher.

The final comment to make relates to the exchange rate, and it appears that the balance of payments implications of raising interest rates and drawing a lot of money into the country as a result of those interest rates are simply not understood, and the impact on the country's balance of payments is far more serious than the benefits that we may get from having low inflation or deflation in the tradable sector of the economy.

English — Can you just explain a bit more on the last point you made, where I think what you meant was that the effect of large capital inflows generated by high interest rates is worse than the effect of higher inflation, is that right?

Rankin — Yes, yes, yes. We see that what has happened is this imbalance or bifurcation, where the inflation of the non-tradable sector becomes distinctly different from inflation in the tradable sector. So we have been seeing over the last year inflation rates of about minus 1 percent in the tradable sector and of about 4 percent in the non-tradable sector. What happens when we raise interest rates is that the tradable sector inflation goes down even more for a short while, but then when interest rates stay high and the exchange rate stays where it is for a while, even that tradable sector inflation comes back. So we actually find that for a short time, we do get some slight lowering of inflation because of the rising exchange rate. It does not last, but the problems that result from these capital inflows that necessitate us to have a current account deficit, what happens if we have autonomous capital inflows that are driven by high interest rates or driven by low interest rates overseas, we get much more money flowing into the country than we need even to service our current balance of payments deficit. That simply puts upward pressure on the exchange rate.

An inflow on the capital account of the balance of payments necessarily induces a deficit on the current account of the balance of payments, and that deficit is really adding to our—indebtedness as a nation—really adds to the amount of our GDP that is claimed by foreign investors.

English — So you talk in your submission about a generally relaxed stance of inflationary pressure?

Rankin — Yes.

English — And a market-driven approach to setting interest rates?

Rankin Yes.

English If you take the current bit of the cycle that everyone is worried about, how would it look under a regime of a more relaxed stance on inflationary pressure—you know, in hindsight, what would it look like?

Rankin What normally happens is the business cycle has its own impact on interest rates. As we have a business cycle expansion, interest rates tend to rise, and in a contraction, they tend to fall. What monetary policy seems to do is to aggravate that effect by pushing interest rates higher in a business cycle expansion than they would otherwise be. My argument is that the normal ebbs and flows of interest rates in the business cycle are sufficient to allocate credit, to manage the market for credit and so on. So, in other words, interest rates would have risen through the expansion but not as much as they have risen as a result of the activities of the Reserve Bank.

English What do you think the inflation track would have been?

Rankin I think the inflation track would have been roughly around the 2 percent mark, but with the difference between tradable and non-tradable much less. So, in other words, tradable would have been higher but non-tradable would have probably been in the 2 to 3 percent mark, I believe, had we not been pushing interest rates up to higher than they would otherwise have been. The necessity to have a high return on capital, the cost and impact of these unnecessarily high interest rates has caused non-tradable inflation to be higher than it otherwise would have been.

Swain I think everybody is sort of on the same page in terms of interest rates, exchange rates, and balance of payments issues. I think that is probably why we are here, actually, fundamentally. The problem with counterfactuals, of course, is that it is a comparative thing—you are looking at what might have happened and, of course, we will never know that. So the question really is that in many of those other countries, there will be some other fundamentals as well that are different: savings regime, productivity arrangements, etc. I am just wondering whether what you are saying is, I think, from what I have read, being more relaxed as inflation starts to move and not come in and jump on the brake.

Rankin Yes.

Swain I suppose the two questions are: how long do you wait before you actually do really start to sweat; and, secondly, are there some fundamentals that need to be in behind to support that ability to wait?

Rankin How long you wait depends. Once you have identified that any inflation that exists has been a process, that means that it is something that needs a cure, because it is an ongoing process, then it is a problem. If it is simply an episode, like if you get a cold or something; if it has clearly not gone away after a couple of months or so then you need to treat it. But these things normally go away after a certain amount of time, if it is just an episode. But once it is clearly a process, policy has a role to play.

Our monetary policy, we are not even waiting for the inflation to happen. We are anticipating inflation and actually treating the problem before it happens, but most of the monetary policy theory relates to how you deal with a process that is well under way and appears to have generated expectations, and those expectations are what are fuelling the process. We do not have any of that inflationary process at the moment, so we are making a problem for ourselves that we do not really have at the moment. But by adding to costs in the economy, by making it harder for businesses to invest, we are creating an inflexibility on the supply side of the economy, which means that an inflationary process is actually more likely rather than less likely.

About counterfactuals, all policy implies some kind of counterfactual—it is not always what is specified—to assess whether policy is working or not. Everybody in that debate must have some counterfactual as a reference to what would have otherwise happened. The implied counterfactual here is that inflation would have been tracking 5, 6, or 7 percent were it not for the policies that we have introduced. My suggestion is that inflation would have been tracking more like 2 to 3 percent without any great problems had we not intervened to the extent we had in monetary policy since 2002, and especially since 2004.

Swain — Actually, on the fundamentals, I mean, there are other things hovering around it—productivity, savings regimes, etc. Have you got a quick comment on that or not?

Rankin — Well, the productivity we need to have flexibility for the supply side to respond, and indeed inflationary pressures is part of what makes it possible. If we have low wages and high interest rates, we are very unlikely to get productivity gains. We want to have incentive to substitute from labour to capital. High interest rates, relatively low wages simply doesn't cut it.

Fitzsimons — Good morning, Keith. Are you concerned that the way in which banks are aggressively pushing credit on to consumers at the moment is contributing to both the exchange rate and the balance of payments deficit—I think particularly credit card limits and also the way that house price inflation is being used to encourage homeowners to up their loans to the maximum in order to pay for the overseas holiday and the new boat and car? Is that connected with your view of the disparity between the effect the bank has had on the non-tradable sector and the tradable sector, and could you elaborate on that connection?

Rankin — Okay, well, in terms of what the banks are doing by raising their funds overseas, by issuing the Uridashi and Euro-Kiwi bonds and so on, they are drawing in this autonomous capital inflow. Of course, they were seeing significant opportunities to profit, because interest rates are low overseas in some countries, they are very high here. By supporting that very big interest rate differential—and we were one end of the spectrum; Japan and Asian countries are at the other—we are just creating absolute heaven for the speculators , because these are unexploited profit opportunities, which normally close, but they are not being allowed to close, because our monetary policy is like a price floor—it is creating a price control that prevents the market from doing what the market will normally do.

Now, having got that funding into New Zealand, the banks then have got to decide how to profit from it by who they are going to lend to. Clearly, with the high exchange rates, anyone in the tradable sector, which is manufacturers, service exporters, and all exporters are not going to be the flavour of the month for banks to lend to, because they are clearly struggling under the high exchange rate. So the banks are going to be much more interested in lending anywhere in the non-tradable sector, which is booming, and especially lending with collateral. It is a lot less risky for them to lend to anyone who holds collateral, and it is in the areas like shares or lending on property that is clearly the most attractive. So the interest rate differential is bringing the money into the country. It is apparently less risky to lend where there is collateral and where prices seem to be rising, which is in housing.

That is a huge imbalance, so it means that we have an inflow of money instead of a reduction in the money supply, and it means that there is a huge flow of resources in New Zealand going from the tradable sector to the non-tradable sector. If we are going to trade our way out of difficulties as a nation, that is the exact opposite of what we need.

Foss: Just a quick one—those Japanese investors, of course, they are not lending against New Zealand collateral; they are lending against the security and collateral of the World Bank or someone like that. But isn't it fair to say that actually without the 100-plus billion that has been let into New Zealand, without that, our interest rates would actually be a lot higher in the 2, 3, four year— Who else would be leaving New Zealand those funds?

Rankin: The money is coming into the country, attracted to high interest rates. If high interest rates were high for some other reason, then that money would be coming in, because it is low in Japan or China or wherever and it is high here. So whatever the reason for the high interest rates, that differential creates an unexploited profit opportunity, which will draw that capital here. Now, they are just lending to the banks through the bank bond issues. It is the banks, of course, who are then making their decisions about what to do with all that funding, and they are select—they are lending to the dairy sector, sure, but much of the manufacturing and other exporters are not investing at the moment, basically because they are contracting. So what the foreign investors are doing is simply taking advantage of the interest-rate differential, and good on them in a way—that is what the price signals are telling them to do.

Whatever the reason for interest rates being higher here will attract that money here, but normally when profit opportunities are being exploited, they close, that differential will narrow. But the Reserve Bank, by holding that differential, through its tight monetary policies is preventing the price differences in different countries from narrowing, creating a process by which money keeps coming into the country, and there is no obvious end to that process.

Smith Gentlemen, we are going to bring this to a close. Keith, I would just like to ask you quickly one question. In relation to your argument about a more relaxed approach to monetary policy and the counterfactuals you mentioned, if you go back to the 1970s and early 1980s—and I am old enough to remember those times pretty well—when there wasn't an independent monetary policy regime in place, what went wrong there that resulted in such massive levels of inflation? Just very quickly.

Rankin I mean, it is a long question, and you would need quite a long look at the whole thing and changes. A lot of the inflationary pressures in the 1970s and 1980s were international, and monetary policy systems in New Zealand changed. But we do see some parallels with what has been happening here in the last year or so with 1986 and 1987 and the way, after the exchange rate was floated, monetary policy allowed interest rates to be much higher than they otherwise would have been, drawing a lot of money into the country, and that was invested in commercial property and shares, and we saw what happened in the bust after that.

In the 1988 to 1992 period, we actually needed some more active monetary policy because, as we saw in the States in the late 1980s and also in the States after 9/11, there was a role for monetary policy when there was a real crisis, and I would argue from 1988 to 1992, New Zealand was in its second-worst economic crisis of the twentieth century—the worst, of course, being the Great Depression. So it is a bit like crying wolf. If we keep applying monetary policy all the time, every couple of months or so, then we lose our ability to apply it when we really need it, when we have a real crisis.

Smith Thanks very much, Keith, for those answers. Thanks for your time you have given us this morning.

Rankin Thanks very much.

conclusion of evidence