Monetary Policy Speech – *Paying our way in the world.*

Tuesday 29 April 2014; 7:45am

Stamford Plaza Hotel, Auckland

Good morning.

A couple of weeks ago, we marked a significant anniversary.

It was 40 years since the start of the Kirk Labour Government's universal savings scheme. The scheme was bold, visionary, and ahead of Australia.

And Muldoon scrapped it, for ideological reasons. With dancing Cossacks and cold war rhetoric, he managed to scare the country that it was all a giant socialist plot.

Looking back, it sounds bizarre that people were sucked in. But he got away with it. And as a nation we are still paying the price.

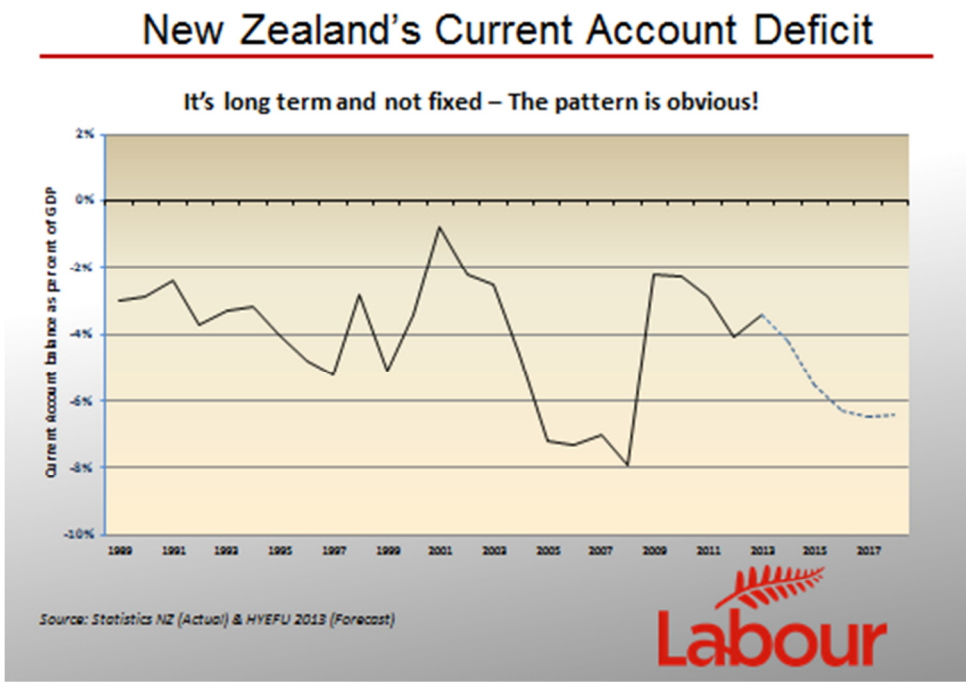
We are heading towards another 40th anniversary, of sorts, but this one will most likely slip by unnoticed.

New Zealand has not had a current account surplus for 40 years.

That's right. It has been 40 years since we paid our way in the world. Even this current financial year – with fantastic terms of trade – we will still have an external deficit.

With a tail wind, maybe we'll get close to negative 2% of GDP. Thereafter, it will be back up over negative 5% to the end of the forecast period.

Forty years living on the national credit card. Forty years of spending more than we earn. Forty years of borrowing and hoping it will all come right in the end, somehow.



There are some who are quite happy to say, in effect, that this is as good as it gets.

What's wrong with borrowing and hoping, they say. What's wrong with kicking the debt can down the road a bit, for someone else to sort out.

We've been doing it for 40 years, and the sky hasn't fallen. There's plenty of overseas money to borrow, plenty of Kiwi businesses and New Zealand land to sell offshore.

Because to these people, monetary policy is sacrosanct, a kind of infallible article of faith, and they vigilantly guard against meaningful change.

Yet history shows that monetary policy needs to be updated periodically.

From chartered companies with exclusive trading rights in return for opening up colonial economies, to the gold standard, to currency controls under Bretton Woods, to independent Reserve Banks and inflation targeting, to post GFC arrangements – monetary policy has always changed.

Change, even sensible change, whose time has clearly come, inevitably has its critics.

In earlier generations we had plenty who wanted to hang on to the gold standard beyond its use by date, and then to Bretton Woods currency controls.

But simply pretending there is no alternative, and protecting the status quo, is not good enough anymore.

I get the sense that for some people, even mentioning a change in monetary policy settings is uncomfortable.

Let me reassure you, because others will try to put words in my mouth.

To be crystal clear, the New Zealand Labour Party remains committed to the independent full service Reserve Bank, which you will remember a Labour government introduced in 1989.

We remain committed to the control of inflation and the existing inflation target, to a floating currency, and free capital movement.

But that does not mean we are blind to the limitations of current arrangements, and we are willing to act to improve them.

After 25 years, it's time to take another look. And who better to do it than those who set up the current system?

Just like Muldoon before them, our political opponents and their ideological cronies will criticise us – accuse us of economic heresy, of rampant socialism, of runaway inflation, of destroying jobs.

All of which is complete nonsense, of course.

The critics of any change to monetary policy occasionally proffer excuses – we are a young country – our net migration explains our need to import capital rather than earn or save it.

Of course, these critics often don't propose any alternative. They say there is no alternative.

They occasionally wring their hands and say feckless New Zealanders don't save or export enough, but are unwilling to concede that monetary policy can be improved to assist.

I find it hard to understand why some deliberately fear broadened objectives for New Zealand's Reserve Bank, when other independent Reserve Banks including the Federal Reserve and the Reserve Bank of Australia already have broader objectives.

Other Central Bank objectives

US Federal Reserve statutory mandate:

" ... to *promote maximum employment, stable prices, and moderate long-term interest rates*".

Reserve Bank of Australia Act:

"In determining monetary policy, the Bank has a duty to maintain price stability, full employment, and the economic prosperity and welfare of the Australian people."

Labour

It stands out like the proverbial that under current settings our export mix is narrowing further and further towards over-dependence on dairy products, and in particular milk powder sales to China.

It stand out like the proverbial that under current settings we will never achieve an external surplus.

And it stands out like the proverbial that under current settings we will borrow billions extra every year from overseas lenders, and sell more and more of our land and companies overseas to fund our external deficit.

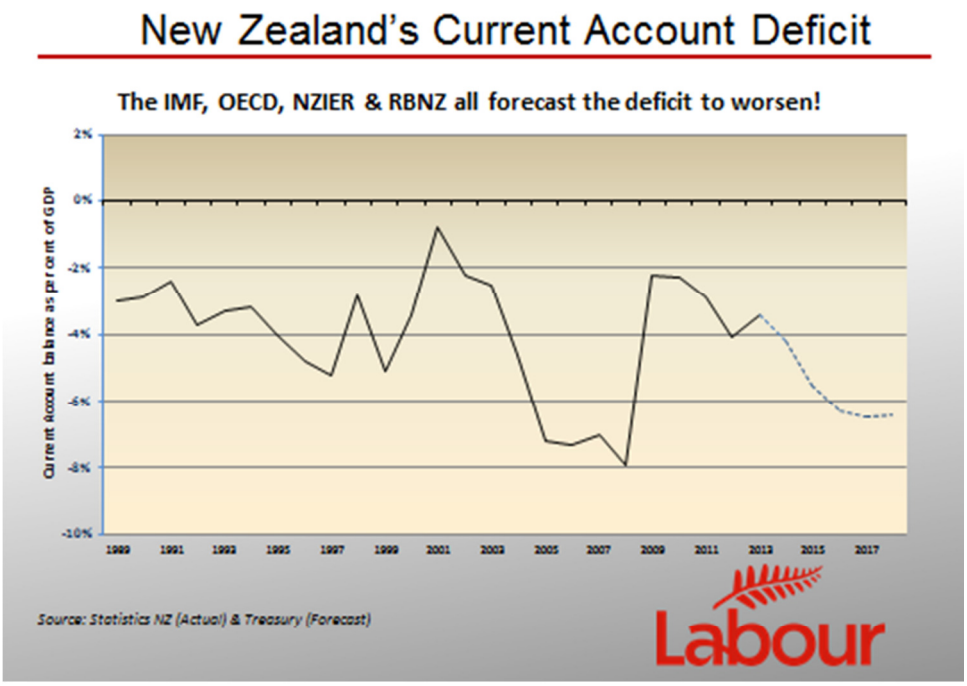
Because let's be clear – that is how we make up the difference between what we earn and what we spend by borrowing and by selling our birth right.

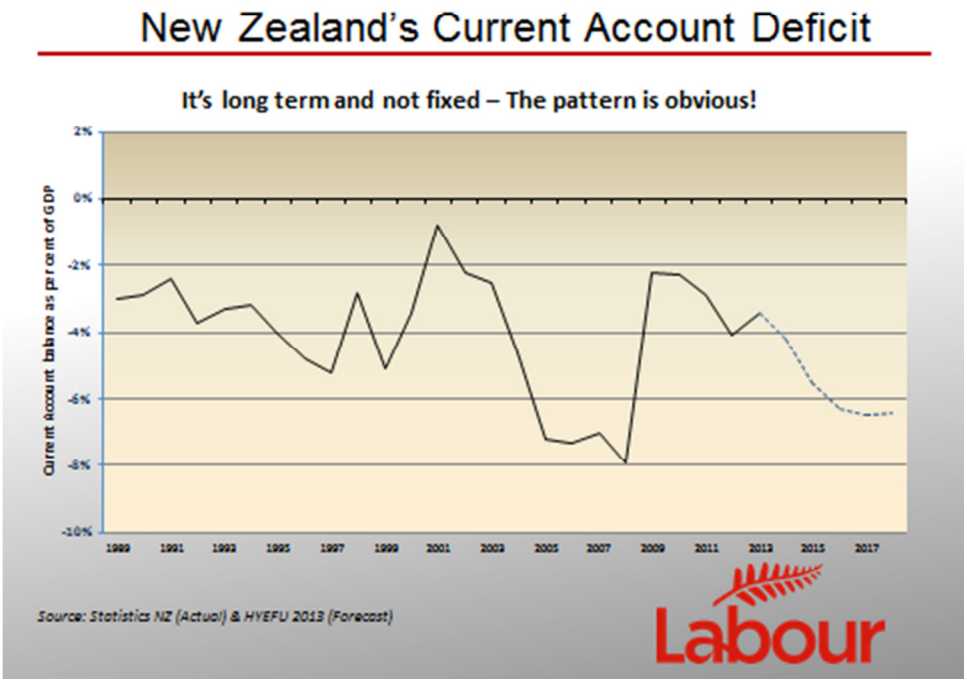
New Zealand's record over recent decades proves this. This history is a fact, not some arguable proposition.

It is fact not fiction that we have not had an external surplus for 40 years.

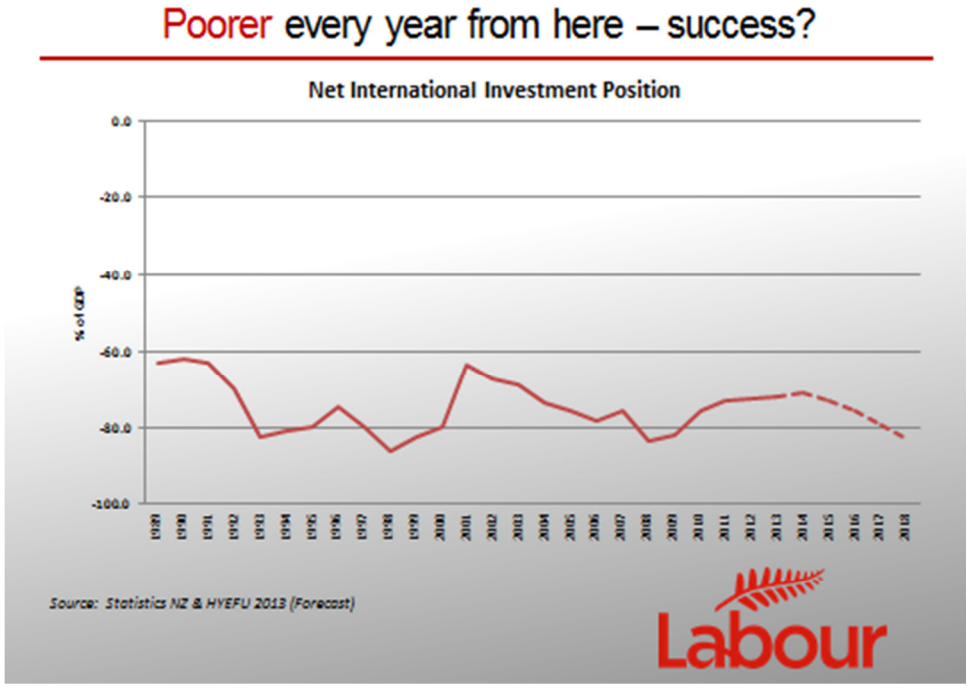
It is fact not fiction that last time we had terms of trade this good we had a current account surplus. This time we are still in deficit.

And it is fact not fiction that the forward projections of the Reserve Bank, the Treasury, the OECD, the IMF, the Banks, the economic consultancies from NZIER to BERL, and the rest, are unanimous in saying our external deficit will return to minus 5% per annum and stay in deficit for as long as they can predict.





And that means our external liabilities – already our greatest vulnerability – get worse.



To alter that course, requires sensible change. It's obvious. Change nothing, and nothing changes.

A successful and fair economy requires a sophisticated matrix of values and settings.

Freedom from corruption, a fair division of income and wealth, respect for property rights and the rule of law, protection of natural capital and the environment, respect for human rights, and an educated and healthy population. These are all important ingredients.

Strong democracies are vital to achieve this mix.

Ours is one of the most successful democracies. Our record of over 150 years of continuous democracy - unbroken by war, civil disturbance or political upheaval - is one of the longest in the world.

The Labour Party is the oldest political party in parliament.

We clock up 100 years of service to New Zealand in 2016. We could fairly claim some of the credit for New Zealand's success, but the real credit goes to generations of inventive, hardworking, everyday New Zealanders.

Judge us from that long history and you will see that it is the Labour Party that has driven most of the important social and economic change over the last hundred years.

Conservative parties tend to trim the sails and tinker, but otherwise are guardians of the status quo. They tend to govern for today, whereas Labour tends to govern for tomorrow.

They tend to eventually catch up, and then become defenders of changes they vehemently opposed which Labour initiated.

Take this current National government.

They inherited zero net government debt because of the huge surpluses Labour ran – which National opposed – and low unemployment.

They inherited KiwiSaver – which they voted against – interest free student loans – which they voted against – and working for families – which they voted against and called communism by stealth.

They have kept them all. They even now begrudgingly praise the Cullen fund, which they opposed and called ‘a dog’ when we introduced it.

Since taking the reins, National’s biggest moves have been to cut income tax for high income earners and put up GST, in their first term, and to privatise the value of the public water which drives the hydro turbines of our power companies, in their last term.

And they borrowed around $65 billion – some for Christchurch – but mostly to keep themselves out of the headlines – and keep smiling.

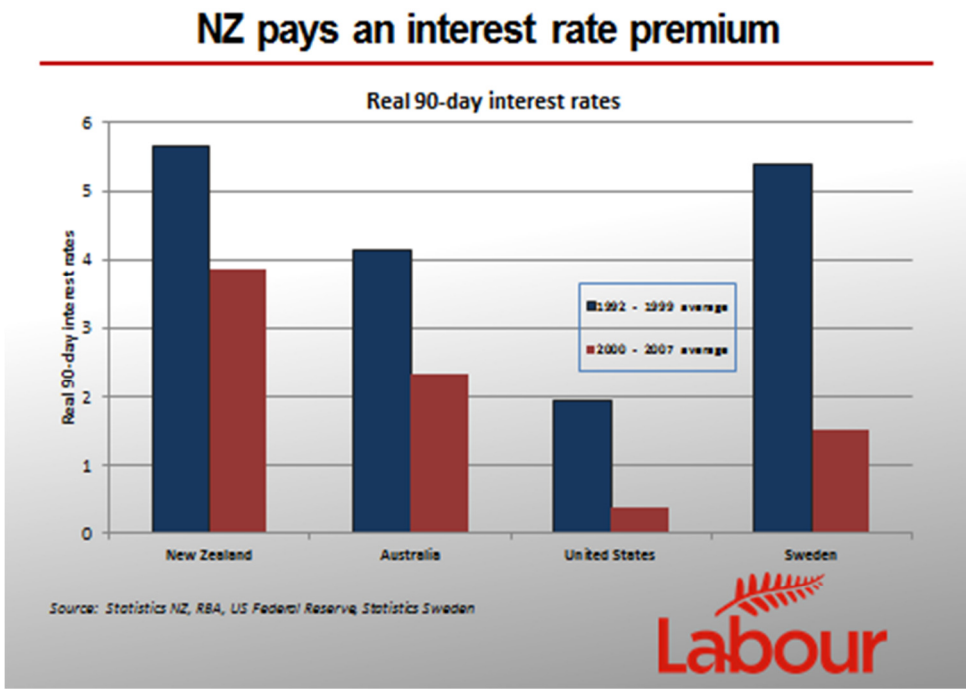
That’s pretty much it after 6 years. National has done nothing significant to address the imbalances they railed against.

House price inflation has continued to outpace CPI inflation and income growth. It’s actually sped up. Home ownership rates are dropping.

Yet they refuse to address tax biases which contribute to rising inequality, and have been astoundingly ineffective at increasing the supply of the affordable houses our country needs to be built.

Their housing policies are a disaster – a total failure – and that failure is contributing to higher interest rates and higher rents – and the collapse of the Kiwi dream of home ownership.

Last quarter New Zealand’s general price inflation was zero – except for the tax rise on cigarettes.



So, despite low general inflation, and with our interest rates already higher than the rest of the developed world, the National government's current settings have our interest rates going up higher still – heading for 8% mortgage rates.

We have had the best terms of trade in a generation, and we still posted a deficit.

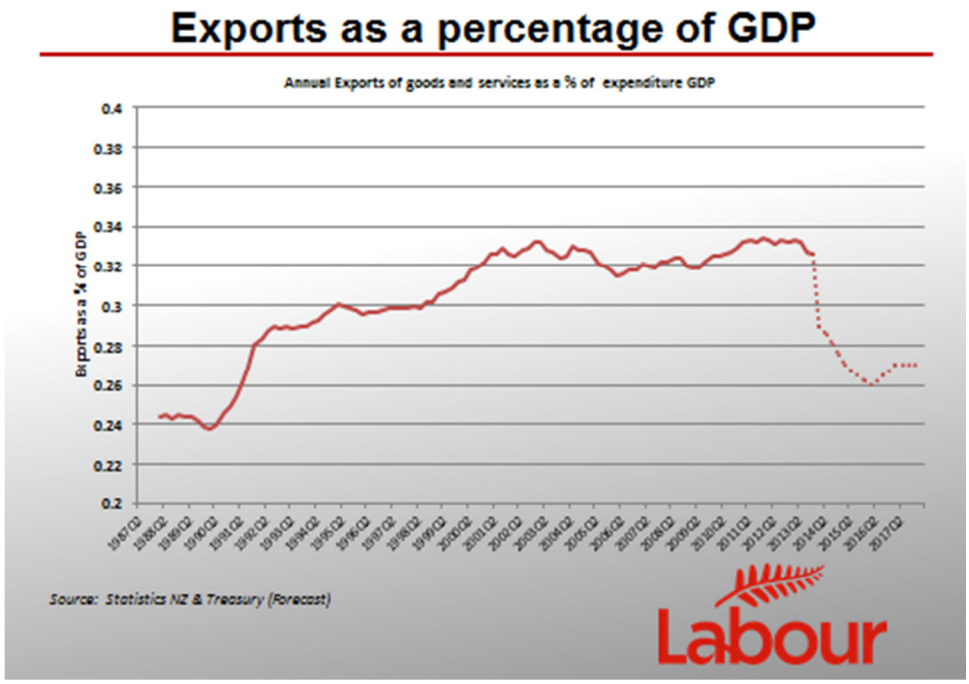
Despite recent drops in export prices, and with higher interest rates, the exchange rate is now going up even further. Our external deficit is set to follow.

The sad truth is our opponents are constrained by their ideology, in this regard.

By definition, they hold back prosperity because their ideology denies them the flexibility to adapt.

Their natural instinct is to stick with the status quo – to blame and scapegoat others.

The current National government's export objective since 2008 has been to increase exports to 40% of GDP by 2025.



Exports were 32% of GDP in 2008. With the best terms of trade for 40 years, exports were 33% of GDP in 2013, and are projected by the Treasury to be 30% of GDP in 2018.

It is clear the admirable objective to lift exports to 40% will not be achieved under current settings. They have failed.

Of course economic policy is complex, but some things are obvious. As I said earlier, change nothing and nothing changes.

We need more exports and import substitution to pay our way in the world and build the wealth of our nation. To achieve this we must improve the competitiveness of our export sector.

A suite of carefully considered changes in macro and micro economic policy will be required.

Our policy package already includes major improvements to investment, innovation and industry.

We will make KiwiSaver a universal scheme, like it is in Australia. This will genuinely deepen capital markets and reduce the cost of capital. If anyone doubts this, consider how it is that the Aussies now own their banks and most of ours, plus so much of the rest of our corporate sector.

Labour has pro-growth tax policies to direct more of New Zealand's existing and future capital into the tradeable sector.

Our capital gains tax pushes against the tax bias which currently encourages capital into the speculative sector at the cost of the productive sector.

In addition to improving the economy, this will make the tax system fairer, and will take pressure off house prices.

As in most other countries, it will not cover owner occupied homes. The family home will be exempted.

Our research and development tax credits encourage innovation, and our accelerated depreciation encourages industry to invest in productivity enhancing plant and equipment.

Our policies push New Zealand's economy from volume towards higher value products and services, both in traditional commodities and new industries.

I know from my discussions with business leaders that it is already widely accepted that we are promoting an integrated series of policies which will lift export performance.

Our well-considered solutions form a joined up roadmap to growth and prosperity.

But significant as these steps are, we do not believe they alone will be enough to lift our export performance to overcome our current account deficit and get our net international liabilities on a sustainable downward track.

We are stuck with high interest rates relative to our competitor nations – higher than they ought to be – and not just in the current cycle, but long term.

We exhibit the very characteristics which the IMF warns can adversely affect macroeconomic stability.

Labour has concluded that the current trend is clear and undesirable, and that monetary policy is partially responsible.

We have concluded that a broader role for the central bank in support of macroeconomic stability would assist, along with a new tool to achieve that broadened objective.

We believe this will help deliver secure and better paid jobs, less inequality and decent returns on our own capital.

We will own more of our own country, and so have more control of our own destiny.

We will also be better able to provide the social supports that New Zealanders know make our country strong and fair. These include universal access to high quality health care and education, and support for the elderly and the vulnerable.

And so we will sustain and strengthen our democracy into the future.

Why does the effect of current arrangements, which largely ignore our overvalued currency, matter so much in New Zealand?

We know we are a small trading nation distant from large markets; that our internal market is small; that we are more reliant on exports than larger economies.

We know this means that exchange rate risks are concentrated for many New Zealand based exporters compared with their competitors.

In other words, we know it is even more important in New Zealand than in larger economies to get these settings right.

Exporters and import substitutors readily understand that economics is multi-faceted, and that addressing the effect of monetary policy on the exchange rate is but one part of the recipe.

Nevertheless, exchange rates are a key determinant of profitability and cash flow generation for the tradeable sector, and hence a major risk factor influencing the ability and willingness of market participants to invest.

While CPI inflation targeting has helped domestic price stability, exporters note that for them effective price stability cannot be divorced from currency levels. On that score the current system fails exporters.

There is a widely held view that New Zealand's currency is overvalued most of the time.

The IMF and OCED have both estimated that the NZ dollar is up to 15% overvalued. Based on OECD figures, HSBC says our dollar is the sixth most overvalued in the developed world.

The Reserve Bank says that it believes, from a long-term perspective, the exchange rate is overvalued. And only last week, when announcing the hike in the OCR, the Bank reiterated the belief that the exchange rate is not sustainable at these levels.

Exporters say, and their reluctance to invest shows, current settings lead to pessimistic projections for the tradeable sector and hence under-investment. Further investment in fixed assets, innovation, and staff depends upon projections of future exchange rates.

Investment decisions are forward looking. It is no surprise that faced with a likely unfavourable future export settings; there has been under-investment in exports and manufacturing outside of the dominant primary processing sector.

Of course perishables in dairy are processed – you can't sell sour milk - but success in dairy is not enough for our country.

Milking more cows, natural disaster recovery, rampant house prices and migration are not an economic policy.

Global and domestic experience over recent years suggest that monetary policy's almost exclusive focus on low inflation, while arguably necessary to bring high inflation under control in the 1980s, has become too narrow for today's challenges.

The experience of the Global Financial Crisis and the period leading up to it has demonstrated the instability that can flow from high credit growth, inflated asset markets and trade imbalances.

It is now widely accepted that central banks will have to assume wider macroeconomic responsibility, with particular focus on emerging imbalances – including in asset markets - that pose threats to medium-term macroeconomic stability.

In the case of New Zealand, the monetary authority's focus should also include the consequences of persistent external deficits.

This is not a criticism of the Reserve Bank. They are doing what Parliament told them to do – target only inflation and publicly advocate for the idea that this is the right thing to do.

Labour has concluded that a change to the objective of monetary policy is necessary, enabled by the deployment of an additional tool to assist in meeting the broadened objective.

It is proposed that the objective of the Reserve Bank be updated and broadened beyond inflation to include achieving a positive balance in New Zealand's external position.

The new objective would be that:

The primary function of the Bank with respect to monetary policy is to enhance New Zealand's economic welfare through maintaining stability in the general level of prices in a manner which best assists in achieving a positive external balance over the economic cycle, thereby having the most favourable impact on the stability of economic growth and the level of employment.

The new Reserve Bank objective

Reserve Bank Act 1989:

" ...to formulate and implement monetary policy directed to the **economic objective of achieving and maintaining stability in the general level of prices**"

Proposed objective:

"...to **enhance New Zealand's economic welfare through maintaining stability in the general level of prices** in a manner **which best assists in achieving a positive external balance over the economic cycle**, thereby **having the most favourable impact on the stability of economic growth and the level of employment**"

Labour

Critics often default to the assertion that changes imply a desire to intervene directly in the foreign exchange market to control the currency, or some intention to limit capital flows, and in both cases tolerance for higher inflation.

Not so. Again, it's the old Muldoon-style scare tactics from the 1970s.

Contrary to this straw man implication, there are a number of options that should be developed, ranked and prepared for activation. These are detailed in the paper we have released today.

Using the mechanism I will describe, the Reserve Bank does not lose control of its inflation target.

The new objective would be operationalised through a revised policy targets agreement between the Governor of the Reserve Bank and the Minister of Finance.

The Reserve Bank would retain its independence, and its obligation to achieve its inflation objective.

Let me repeat, so as to avoid any misunderstanding, the Reserve Bank would retain its independence, and its obligation to achieve its inflation objective.

Are we clear, or do I have to say it again?

The new policy targets agreement would include the existing inflation target, which would remain unchanged.

The external balance objective in the policy targets agreement would state the government's objective for the external balance. This would include both an objective range for the medium term, and a longer term trend objective towards a positive external balance.

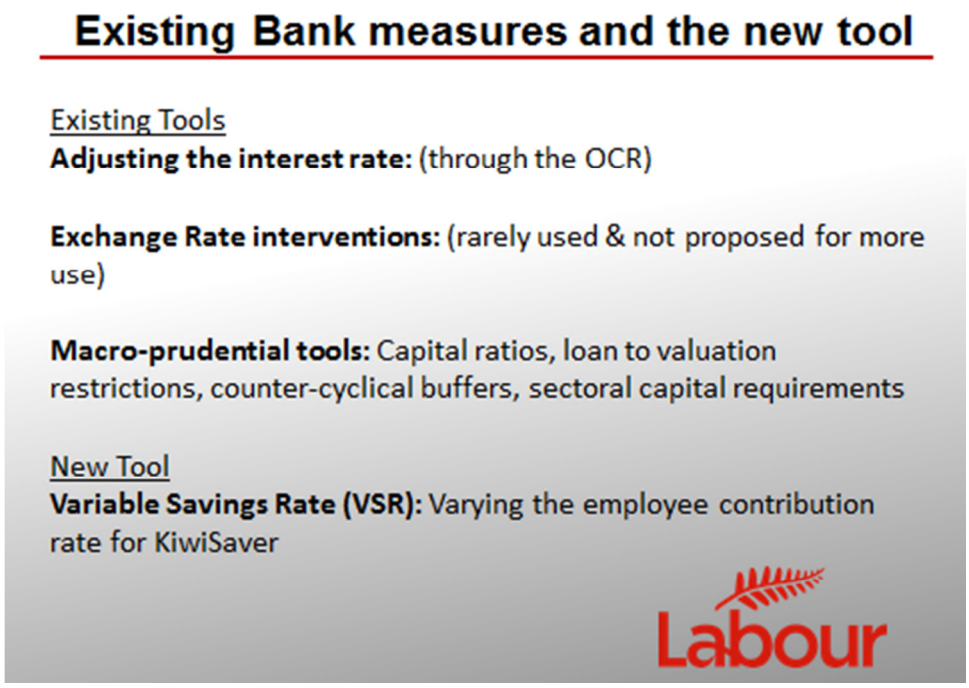
The objectives set by government will be influenced by projected long term growth rates and the desired level of net international liabilities.

The achievement of a positive external balance will be a multi-year process and will involve a downward correction of the exchange rate to a sustainable level. The adjustment may be less drawn out than current economic models would suggest.

A macroeconomic strategy credibly focused on a more competitive exchange rate and the external balance along with a change in the mindset of policy-makers will encourage higher rates of investment in the tradeable sector than experienced under the current policy regime.

The agreement would invite advice from the Bank as to what mix of instruments would best achieve the new broadened objective.

Three categories of tool are identified - existing tools, a new tool and other measures.



The existing tools of the Reserve Bank include adjusting the interest rate (through the official cash rate), foreign exchange purchases, and so-called macro-prudential tools such as capital ratios, and loan to valuation restrictions.

I expect the Reserve Bank will consider whether the broadened objective is better achieved through a varied use of the Bank's existing tools.

Overall, interest rates will be lower and so will our overvalued exchange rate.

We propose an important new tool – varying the employee contribution rate for work based savings. The **variable savings rate** mechanism – or **VSR** – would allow the raising or lowering of savings rates, rather than interest rates, to reduce or boost local consumption.

Of course, a universal KiwiSaver scheme is necessary, as we are proposing.

Instead of paying more interest on your mortgage, a similar amount of extra savings would go into your KiwiSaver.

Higher interest payments are lost to the lender, with much of it heading overseas, whereas savings would belong to the saver.

As everyone is enrolled in KiwiSaver, and as contributions are increased over time from the current 6% towards the intended total of 9% of earnings, consumption pressures will be lower.

The policy targets agreement would set out the government's intentions in respect of savings. During this transitional period, the Reserve Bank should be able to manage inflationary pressures with lower interest rates than would otherwise be necessary.

The policy targets agreement will request that the Reserve Bank use this once in a life time opportunity to attempt to get underlying (as opposed to cyclical) New Zealand interest rates back to the lower levels charged in our competitor countries.

The policy targets agreement would state whether or not it was the government's expectation that over the economic cycle Reserve Bank variations to the KiwiSaver rate would be neutral.

Using changes in savings rates as an alternative to changes in the official cash rate would mitigate the currency effects of higher or lower interest rates, and reduce overseas transfers on the proportion higher interest payments which currently go to overseas lenders.

Distributional and hardship effects for the lower paid would need to be considered, but could be accommodated in the detail of how the variable rate was applied.

Labour would ensure that everyone was treated fairly.

As I mentioned earlier, it may sometimes be appropriate for the government of the day to choose not to use of the new VSR mechanism, because the multiple objectives which governments have to balance are broader than monetary policy outcomes.

The contrary view is that enabling the Reserve Bank, within parameters, to deploy the new VSR mechanism would assist in de-politicising its use.

The current proposal is that the Reserve Bank only have the power to recommend the use of the new VSR mechanism. Where alternatives to an increase in the official cash rate are excluded, the Reserve Bank would instead use the OCR.

Additionally, the Governor could recommend other measures for the government to consider. These would not be substitutes for current OCR decisions, but would be identified as important topics for the government to address, and are addressed in the paper released today.

With a wider responsibility for macroeconomic stability, the Reserve Bank would explicitly consider the trade-offs associated with its policy decisions and recommendations.

The analysis supporting the possible use of the new tool instead of the OCR, and what trade-offs are involved, would be included by the Reserve Bank in advice to the government each time it is due to makes its determination of the official cash rate.

The Treasury would also provide its own advice to the government, independently of the Reserve Bank.

Arguments can be put for and against, just as arguments can be mounted for and against use of the OCR.

If the government chose not to use alternative tools, the Reserve Bank would use its interest rate lever.

The Reserve Bank thus maintains control and responsibility for achieving its inflation target.

The policy work on other longer term policies, which could be used to assist the Reserve Bank to achieve the broader mandate, would be carried out by the Treasury in consultation with the Reserve Bank.

This process will expose the important trade-offs involved. It will aid in public and political understanding and lead to better decisions for the betterment of the tradeable sector and New Zealand's external position.

This does not mean we are going soft on inflation. The crippling effect of high and volatile inflation is clear.

No positive growth/inflation trade-off exists in the long run. On the contrary, uncertainty about the inflation outlook adversely affects decision-making by households and businesses, and lowers the potential growth rate of the economy over time.

High inflation is hardest on those who lack the means to buy and leverage assets which inflate in value.

High inflation, especially in the absence of any capital gains tax, encourages speculative investments in land and buildings to the detriment of investment flows into productive capital equipment.

The high interest rates associated with high inflation also increase the cash cost of investing in that capital equipment needed to improve productivity and maintain export competitiveness.

It should be acknowledged that while New Zealand has succeeded in keeping inflation low since the Reserve Bank Act, the international trend was for lower inflation anyway. Some inflationary pressures would have abated even without the Reserve Bank Act.

The spike in imported energy costs passed. The effects of the communication and information technology revolution included major advances in automation. These technology changes combined with lower labour costs in rapidly industrialising emerging markets markedly deflated the price of most consumer goods.

While the success of the Reserve Bank Act 1989 is reasonably clear - low and stable inflation - we should not be blind to the limits and side effects of current monetary policy.

Other countries have achieved control of inflation without, as is the case in New Zealand, a prolonged current account deficit or interest rates higher than international norms.

The changes to monetary policy I have announced today are substantial.

But they are not radical.

Summary

- Reserve Bank independence retained
- Inflation anchor unchanged
- Floating exchange rate unchanged
- Freedom of capital movement unchanged
- Control over price stability remains with RBNZ
- Additional objective of positive external balance
- New tool of Variable Savings Rate (VSR) introduced
- Government policies joined up with monetary policy and vice versa

Labour

Under the policy I have announced today, the Reserve Bank's independence is preserved, the inflation anchor is maintained, as is the floating exchange rate, and the freedom of capital movement, as is the ability of the Reserve Bank to stimulate the economy so as to avoid deflationary traps.

But we believe there are tigers other than inflation to be tamed.

Our changes to monetary policy, in combination with the other policies I have discussed, will result in higher exports.

This means higher per capita national incomes, better jobs, higher wages and lower interest rates.

We will reduce New Zealand's net international liabilities, and have better control over our future.

Politicians can't do everything. We have to prioritise.

Significant change requires cooperation with businesses – with both capital and labour. It also requires the various arms of governments to hear clearly what politicians want to achieve.

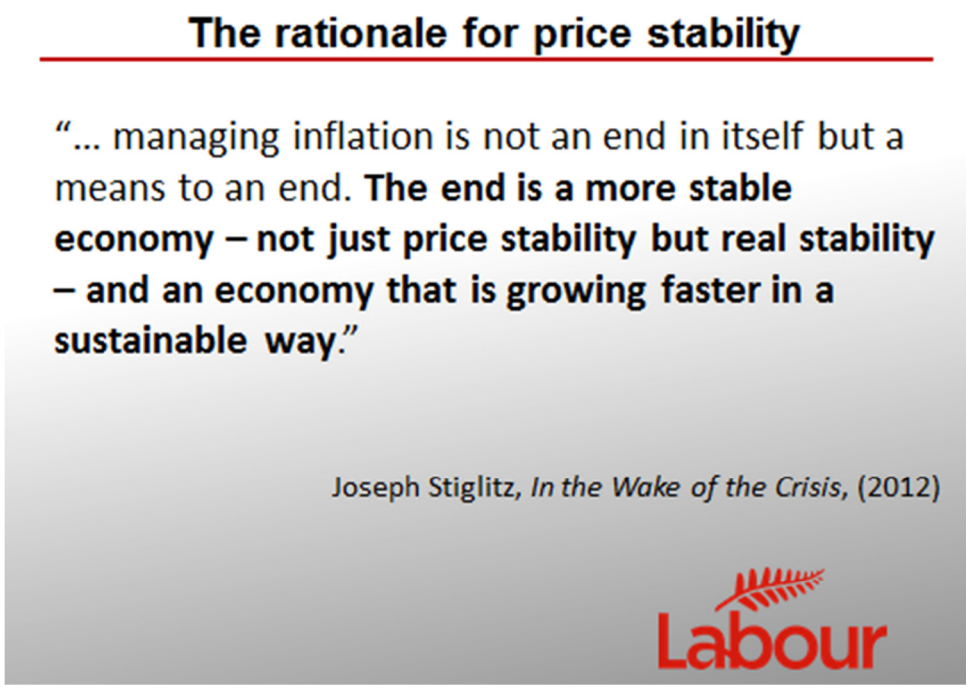
It helps when politicians underline their plans by agreeing to be judged on the success or failure of the metric they have chosen. I am more than pleased to hold myself to account before the public.

These new settings will mean we can start down the long road to living within our means, as a nation, by earning our way and paying our way in the world – for the first time in 40 years.

It is an ambitious target that will deliver structurally lower interest rates, greater investment in the export sector, and well-paid sustainable jobs.

Moreover, we will own our own country again, control our own future, pay our own way and stand on our own two feet.

I end by reminding us all of the obvious, which we sometimes forget.



As Joseph Stiglitz has said, "… *managing inflation is not an end in itself but a means to an end. The end is a more stable economy – not just price stability but real stability – and an economy that is growing faster in a sustainable way."*

And that is what Labour's policies will deliver.

Outcomes

- Lower interest rates closer to international norms
- A more competitive exchange rate
- Increased exports
- A more balanced economy
- Better jobs
- Higher incomes

Labour

ENDS