



BERL's Supplementary Note on the Operation of Monetary Policy

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The current operation of monetary policy is aimed at controlling inflation by the Reserve Bank (RBNZ) using a single interest rate rule. BERL is concerned that this operation causes costs in the country, including contributing to the present weakness in the financial sector.

In choosing inflation control over other objectives we are trading-off progress towards other economic and social objectives. These trade-off choices need to be measured explicitly and transparently. To assist the Committee we have researched and prepared this brief supplementary submission.

Main functions of the Reserve Bank

Two of the main functions of the RBNZ, as a central bank, are:

- promoting the maintenance of a sound and efficient financial system; and
- operating monetary policy to maintain price stability.

BERL's concern

BERL contends that the present lack of soundness in the financial system is to some extent one of the costs of the operation of the price stability objective of monetary policy relying solely on an interest rate rule.

Our reasoning is that the appropriate levels of interest rates and the appropriate growth in money supply are both essential to maintaining a sound financial sector. This was a position reasoned strongly by the late Professors Bryan Philpott and David Sheppard, and Professor Allan Catt, in the BERL submission calling for changes to the Reserve Bank Bill in 1989. The changes were not made, and BERL has highlighted the same need from time-to-time since.

Our present review of the experience 1989 to now is that, by using an interest rate rule alone, based on an objective for forecast inflation alone:

1. The RBNZ upon forecasting inflation above the range is required to lift New Zealand's relative interest rates above the average of international rates.

This action can have the following unintended consequences:

2. It attracts foreign funds into NZ\$ deposits, increasing NZ's domestic money supply.
3. With the deregulated financial sector, and competition in the mortgage market, this increased money supply is expected to

- enable an increase in house prices¹; and
- push money into sub-prime lending situations (even to offshore subsidiaries as with Bridgecorp and Nathan)

thereby reducing the soundness of the financial sector.

4. The process of foreign funds flowing into NZ causes wide fluctuations in the NZ\$ exchange rate thereby reducing the soundness of the tradable sector.
5. The house price increases reduce housing affordability generating associated social costs.
6. House price increases are associated with increases in household consumption. The RBNZ can interpret these consumption increases as threatening to increase forecast CPI inflation.
7. Under the RBNZ single interest rate rule it is required to increase NZ's relative interest rates.

RETURN TO 1. above.

(This cycle can continue for a period until the market finds unacceptable an aspect of the NZ monetary situation e.g. the exchange rate or current account deficit, and withholds funds.)

We believe that these unintended consequences, of operating the interest rate rule on the basis of forecast inflation, include a reduction in the performance of the RBNZ's other main function – namely maintenance of a sound financial system. There are a number of other probable indirect effects on aspects of saving and investment in New Zealand.

Supporting evidence

Each of the steps in our analyses above are borne out by authoritative international findings. We leave you with two quotations.

Firstly, advice given in 1998 on *The robustness and efficiency of monetary policy rules as guidelines for interest rate setting by the (new) European Central Bank*, John B Taylor of Stanford University:

“It is useful for central banks to keep track of monetary changes and perhaps monitor policy rules for the money supply or monetary base even when they are using interest rates rules as a guideline.”

Secondly, Robert Lucas (of the ‘Chicago School’ of monetary economists) in his 1995 Nobel Lecture: “Central bankers and even some monetary economists talk knowledgeably of using high interest rates to control inflation, but I know of no evidence from even one economy linking these variables in a useful way”. And “...the simple correlation between inflation and money growth .. (in 110 countries) .. is 0.95.”

The BERL research is a work in progress that we shall continue towards better outcomes for the country.

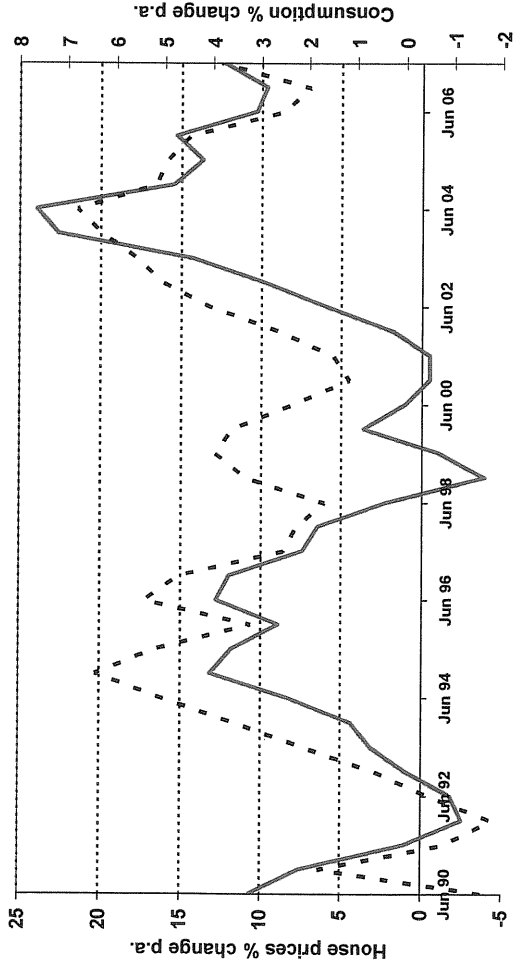
We now show the simple and general tracks of related variables since 1990 diagrammatically.

¹ RBNZ: *Submission to the Commerce Commission on the inquiry into housing affordability in New Zealand*. 2007. Page 8.

RBNZ Process

Consumption increases :
RBNZ forecasts inflation

RBNZ increases
relative interest rate

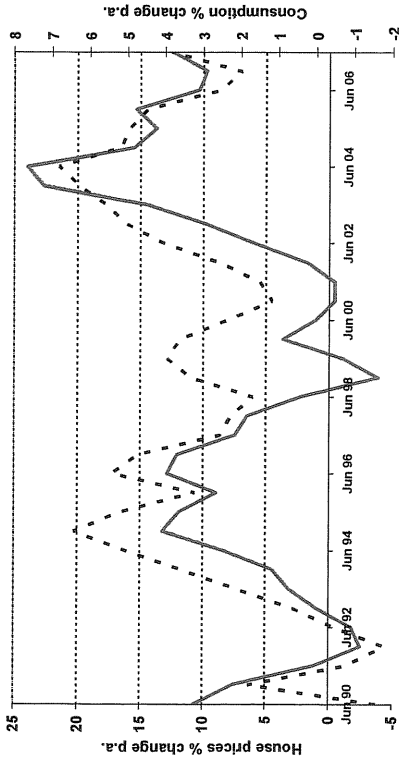


— House prices % change p.a. - - Consumption % change p.a.



House prices
increase

BERL: Unintended consequences



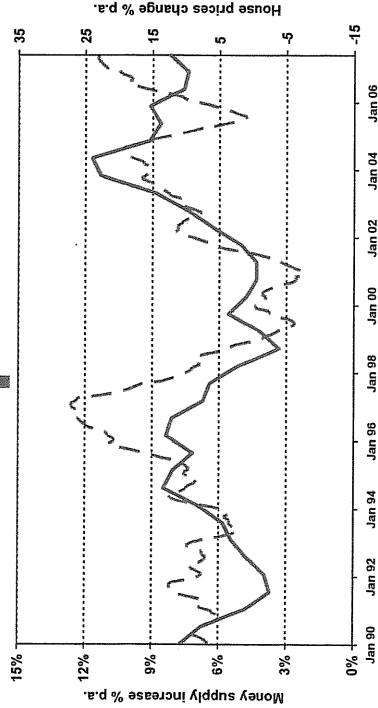
— House prices % change p.a. - - Consumption % change p.a.

House prices increase

**Consumption increases :
RBNZ forecasts inflation**

**RBNZ increases
relative interest rate,
attracts foreign funds**

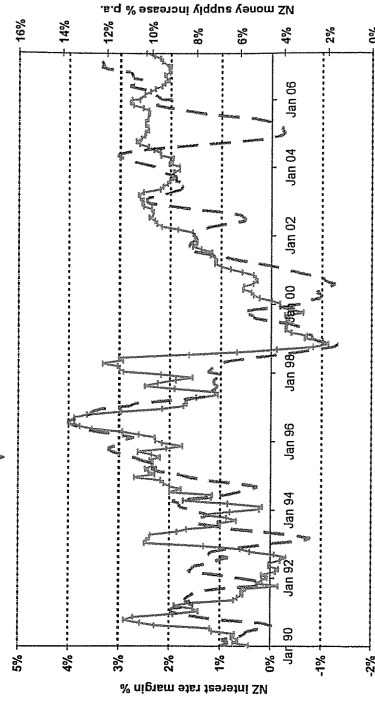
**NZ\$ Exchange
rate increases**



— Money supply increase — House prices % change p.a.

**Money Supply
increases**

**Lending scope
extends to sub-prime**



— NZ interest rate margin — Money supply increase