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RODNEY'S RAVINGS

The costs of the latest monetary policy experiment

EXECUTIVE SUMMARY

Many will assume this Raving is about the Reserve Bank's recent interventions in the foreign exchange market. It is not. The attempt to push down the NZD by the Reserve Bank (RBNZ) is an exercising in being seen to do something rather than a realistic attempt to help exporters. It was never going to achieve much and could even be counter productive, but it means Governor Bollard, and indirectly Finance Minister Cullen and the government, can't be accused of not caring.

This Raving is about the "go for growth" experiment with monetary policy pursued since Governor Bollard took up the helm in September 2002. It is about exporters not only facing an excruciatingly high exchange rate, but also labour costs that are rising faster than their international competitors, low to negative labour productivity growth, and over the top construction costs. It is about the thousands of gullible investors who will see their dreams go down the tube at the hands of a central bank that experimented with low interest rates and fuelled the speculative bubble in the property market that the investors found irresistible.

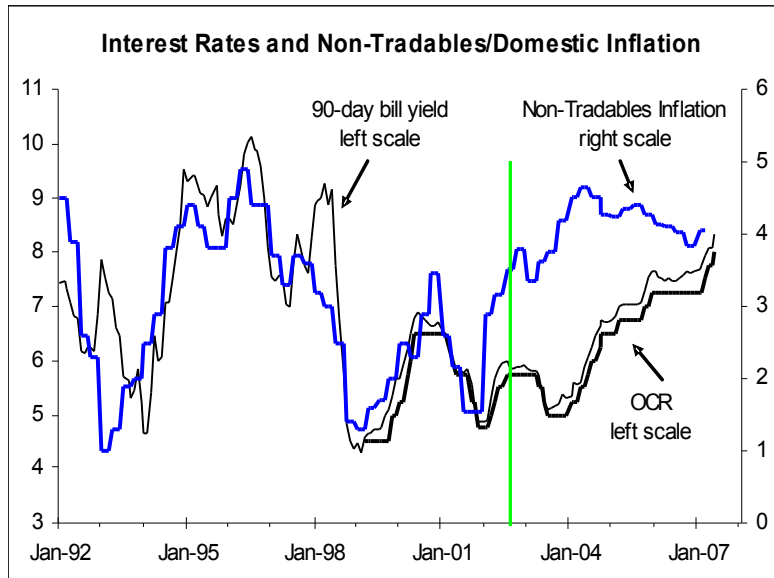


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The “go for growth” approach to monetary policy

The chart below documents the changing of the guard at 2 The Terrace - home to the RBNZ – in September 2002 (see the green line). To the left of the green line is the Brash-era, including the period when Rod Carr was Acting Governor. To the right of the green line is the Bollard-era and the “go for growth” approach to monetary policy.



The blue line in the chart is the measure of non-tradables or domestic inflation initiated by the RBNZ (right hand scale). Non-tradables or domestic inflation is the best available measure of local inflation which abstracts from the direct impact of exchange rate movements. Currency cycles will come and go, suppressing or boosting overall CPI inflation along the way, but if the RBNZ wants to make sure it keeps inflation under control “on average over the medium-term” it needs to make sure non-tradables or domestic inflation is under control.

During the Brash-era the 90-day bank bill yield largely shadowed domestic inflation. When the Official Cash Rate (OCR) was brought into the world in early 1999 the shadowing of domestic inflation continued (see the chart). Then enter Alan Bollard as Governor in September 2002.

Despite non-tradables inflation heading above 3% in late-2002 Governor Bollard kept interest rates well below the historical average for two years. He was making sure that monetary policy didn't get in the way of the economy achieving its growth potential, which had considerable support at the time, with mine being a lone voice warning that it would fuel inflation and require much higher interest rates.

In 2004 Bollard started to realise he had a domestic inflation problem on his hands and he hiked the OCR six times, but even by the end of 2004 short-term interest rates were still below the level that history taught us was needed to get domestic inflation back under control. The continued below average level of interest rates played a critical part in creating a labour market monster, as well as a supercharged housing market. As covered in our **Interesting Times** reports, the labour market not the housing market is at the heart of the domestic inflation problem and this problem has no intention of playing dead any time soon.

Post 2004 monetary policy has been run on the basis of a wish and a prayer (i.e. nudge the OCR higher a couple of times then hope it is enough to sort out the domestic inflation problem, just to find it is not enough ...). Again, as covered in our **Interesting Times** reports, the RBNZ still does not realise the extent of the domestic inflation problem it has fuelled by the “go for growth” approach to monetary policy. But that is not the focus of this Raving. This Raving gives a flavour of the consequences that will follow Governor Bollard's misguided experiment with low interest rates.

The future and beyond

Governor Bollard's experiment with low interest rates has not saved NZ exporters from experiencing a painfully high exchange rate. As covered in the Raving “**What drives the major cycles in the exchange rate**” (<http://www.sra.co.nz/literacycentre.html>), the experiment with low interest rates actually fuelled the high exchange rate by supercharging the economy and housing market. But what NZ exporters now face



as a result of the experiment is a devastating combination of a high exchange rate, larger labour cost increases than their international competitors are experiencing, low or even negative labour productivity growth, and much higher construction costs - assuming they decide to build a new factory - than they would have faced otherwise. No wonder the Canterbury Manufacturers Association Chief Executive, John Walley, is encouraging the RBNZ to sort out the domestic inflation problem sooner rather than later.

“Canterbury manufacturers say the Reserve Bank must send a strong message tomorrow that it is willing to tackle domestic inflation, or see more business restructuring. Pushing up interest and exchange rates would be painful "but pushing through a short period of acute pain is preferable to the attrition of another 1000 days of an overvalued currency," Canterbury Manufacturers Association chief executive John Walley said.” (Source: NZPA, 6 June 2007)

The boom times have been great, but a multi-year boom means a multi-year hangover. The unhealthy tight labour market will usher in much economic pain (again, see our **Interesting Times** reports), but the saddest outcome of the latest monetary policy experiment will be the large number of gullible property investors that get burnt badly over the next several years. And the large number of small businesses that set up to service the booms in house sales, house building, apartment building and subdivision activity that find demand for their services plummet. And about the financiers that get burnt.

Buyer beware and all that, but when the central bank partakes of an experiment that plays a key part in fuelling a speculative bubble in the housing and section markets I find it rich for the Governor to point the finger at investors, warning them that the boom could end in tears, and asks the government to cut immigration and argues for eliminating deductibility of tax losses on housing investments. As covered in the last Raving (“**The house, section, lifestyle and coastal markets are starting to creak**” - use the link above to access this report), the tip of the disaster that will unfold in the property investment markets is starting to show its ugly head. By the time this disaster has unfolded thousands of people, make that 10s of thousands, will have sorry stories to tell about their get rich quick plans. Although some will be too occupied licking their wounds and trying to avoid bankruptcy to rush to the gloating media to tell their sad stories.

But this is not just a story about a misguided monetary policy experiment encouraging lots of gullible people to rush around the country buying “cheap” property investments that end up biting them in the buttocks. It is a story about wasted resources. It is a story about too many of the country’s scarce resources being ploughed into shoe-box apartments in Auckland, coastal apartments in the likes of Whakatane, the Mount, Whitianga and Tutukaka, excessive subdivision activity in numerous provincial towns, and an avalanche of coastal subdivisions (i.e. the sorts of activities fuelled by sustained low interest rates).

The history of investment bubbles – be it ostriches, goats or international IT shares – tells us that you can’t stop many people making naïve and ultimately painful investment decisions, but you would hope that the RBNZ had better judgment than to fuel a speculative bubble that gullible investors find irresistible. If there is any poetic justice in this tragedy it is that Governor Bollard will still be at the helm while the fallout from his monetary policy experiment unfolds.

RODNEY’S RAVINGS – past reports

The reports with bold titles are available in the **Literacy Centre** of our website www.sra.co.nz

The house, section, lifestyle and coastal markets are starting to creak, 6 June 2007

The supper tanker economy, 14 May 2007

What really drives the major cycles in the exchange rate, 30 April 2004

How strong can growth be on a sustainable basis? 16 April 2007

Interest rates and the WACC theory of economic growth, 11 March 2007

Interest rates, inflation and some valuable insights, 2 March 2007

Monetary policy – 2007 kicks off with a roar, 24 January 2007

The NZD and the return of the virtuous economic cycle, 28 November 2006

The all important questions about the labour market, 20 November 2006

A pre-Christmas surge in consumer spending, 6 November 2006

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Exposing the Reserve Bank’s jiggery-pokery, 9 October 2006

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