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New Zealand: Labour Party Proposes to "Upgrade" Monetary Policy

Detail

Today the Labour Party, the major opposition party in Parliament, announced proposals to “upgrade” New Zealand’s monetary policy framework and implementation should it find itself in a position to lead a government following the next General Election on 20 September. This upgrade is motivated by the Labour Party’s concern about New Zealand’s history of persistent current account deficits and high net external liabilities, which are thought to reflect the high level of the exchange rate and persistently higher domestic interest rates than seen in other comparable countries. According to the Labour Party, the upgrade will deliver lower interest rates, a lower exchange rate and better external balance.

The key points to note from the announcement are the following:

- The RBNZ will remain an independent institution and its inflation target within the Policy Targets Agreement will remain a 1-3% increase in the CPI on average over the medium term. The exchange rate will remain floating and there will be no capital controls, although non-resident purchases of existing houses and farm land will be banned. The RBNZ would retain responsibility for setting the OCR.
- The RBNZ Act will be amended from its existing objective of “*To formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices*” to a new objective of “*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 Policy Targets Agreement would state the Government’s objective for the external balance. This would include a both an objective range for the medium term, and a longer term trend objective towards a positive external balance.
- The Labour Party says that it would directly reduce pressure on inflation by (1) running fiscal surpluses (2) making the present voluntary KiwiSaver savings scheme compulsory for employees and (3) introducing policies to ease pressure in the housing market and on land prices (e.g. the building of 100,000 affordable homes over 10 years, the introduction of capital-gains taxes on investment property) (4) controlling the price of electricity (5) investigating using migration policy as a counter-cyclical tool (net inward migration tends to be pro-cyclical).
- With respect to KiwiSaver, the current 6% contribution rate (3% employer and 3% employee) would be progressively raised by 0.5% to 1% per year to reach a target total contribution of 9%. Rather than being voluntary, this would be a compulsory for all employees, but would not apply to non-employees (e.g. the self employed, those retired or on other welfare benefits).
- The RBNZ would be required to consider whether its broadened objective could be met by a better balance of existing tools, including more use of

recently introduced macro-prudential tools that hitherto has been primarily motivated by prudential considerations.

- The Labour Party would introduce a new tool – one that would probably be implemented by the Government on the recommendation of the RBNZ – called the Variable Savings Rate (VSR). The VSR is a discretionary change in the target KiwiSaver savings rate within a defined range around the central rate of 9% (it is intended that the policy operate neutrally over time). The Labour Party would consult the Treasury and RBNZ on how the tool could best be implemented. The Labour Party notes that "*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 designed (for example by excluding lower income earners, whose savings are lower)".*

Market reaction and our initial reaction

There was no market reaction to the Labour Party's announcement**,** despite the promise that the policy will lower interest rates and the exchange rate. We think the lack of reaction is understandable for a number of reasons:

- Given current polling it is most likely that the Labour Party will not be in a position to form a government following the General Election (although it is important to note that it would not take a large swing in vote towards the centre-left to make this a possibility).
- Even if the Labour Party is elected, the policy would likely not begin to be introduced until sometime later in 2015, and even then the introduction of compulsory KiwiSaver contributions at a higher rate will be phased in over a number of years (as much as six years).
- Substitution between KiwiSaver-based saving and other forms of savings means that the total increase in savings will likely prove less than the flow of new saving into KiwiSaver schemes. At the margin it seems reasonable to think that the OCR would be a little lower than otherwise during the transition period, but perhaps not by much. Substitution effects will also blunt the impact of the VSR over the economic cycle. For those on low incomes and with no voluntary savings the VSR will have an impact, but much less so if exemptions are made for those on low incomes.
- To the extent that raising the VSR allows lower interest rates than would otherwise be the case, those consumers not enrolled in KiwiSaver, as well as those with voluntary savings beyond the KiwiSaver rate, would face a reduced incentive to save and an enhanced incentive to consume (the cost of present consumption falls), working against the intention of raising the KiwiSaver rate. There would also be distributional impacts from a narrower segment of the population facing the burden of an overall tighter macroeconomic policy stance.

In summary we think that there is some merit in at least considering some of the proposals contained within the policy package (the ban on non-residential purchases of existing homes and an investigation of whether migration flows could be made less cyclical come to mind). We think that the centre-piece proposal of a universal KiwiSaver policy (for employees) at a higher rate with subsequent discretionary changes merits consideration as a potential countercyclical tool. Unfortunately, for the reasons noted above, we suspect that the enduring impact on interest rates and the exchange rate are likely to be much smaller than the Labour Party would hope for, but some formal modeling of the likely impact would be useful. Given our doubts, anything other than a very unambitious and generalized medium-term target for the external balance within the new Policy Targets Agreement would likely prove unachievable. It is doubtful that the present RBNZ Governor would be prepared to sign up to a more specific target for the external balance, in our view, given that the overall savings-investment balance in the economy depends on far more than is within the control of the RBNZ (or the Government for that matter).

Appendix 1

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