Westpac

Institutional Bank

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Sensibly modest

Labour Party monetary policy proposals

- Labour proposes widening the RBNZ's mandate to include external balances.
- The RBNZ would gain a new tool with which to achieve its wider mandate – a variable compulsory savings rate.
- At first glance these seem reasonably sensible proposals, but we suspect they will have only a modest effect on the economy and the conduct of monetary policy.

Today the opposition Labour Party announced its proposal for changes to New Zealand's monetary policy regime. In our opinion this is an interesting proposal that merits careful consideration rather than knee-jerk reactions. But for what it is worth, today we will outline our initial thoughts.

Labour is proposing three relevant policy changes:

- Giving the RBNZ a dual mandate to target both inflation and "positive external balances" (a higher savings rate).
- Making KiwiSaver compulsory, and over time lifting the total contribution rate to 9%.
- Giving the Reserve Bank some ability to vary the rate of compulsory KiwiSaver contributions, through a new tool called the Variable Savings Rate (VSR).

This seems an internally-consistent set of proposals. Giving the Reserve Bank an extra tool would allow it to pursue a second target without jeopardising its inflation target.

We suspect the effect would be fairly modest. The proposed compulsory KiwiSaver scheme would lift national savings by only about 0.6 percent of GDP. And the VSR would be able to attenuate interest rate and exchange rate cycles only a little – a one percentage-point hike in the VSR would be equivalent to an OCR hike of about 10 to 15 basis points.

We were particularly heartened by Labour's commitment to an independent central bank pursuing a 2% inflation target. Inflation much above or below 2% is known to damage economies, but officials facing election often lack the will to stop inflation from creeping higher. We were worried that a proposal to slacken the inflation target or reduce the central bank's independence was in the offing, but that was absent.

For financial markets, this proposal is one of several in the Labour Party policy platform that all lean in the direction of temporarily lower domestic demand, interest rates and exchange rates – the direction of market risk around the election is clear. What is less clear is whether Labour's proposal would have much long-run effect. We suspect that today's proposal would produce a small permanent reduction in New Zealand's long run average interest rates, but no change to the long run average level of the exchange rate.

The policy proposals in detail

1.New Reserve Bank Act

At present the Reserve Bank Act states that the single goal of monetary policy is "stability in the general level of prices". The definition of stable prices is specified in the Policy Targets Agreement – this has varied over time, but is currently 2% annual inflation. The Reserve Bank is independent to pursue its inflation target.

Labour proposes to change the Act so that the Reserve Bank is required to maintain "stability in the general level of prices in a manner which best assists in achieving a positive external balance over the economic cycle." This essentially means the RBNZ will be required to achieve both 2% inflation and a higher rate of national savings, perhaps defined by some numerical target for the current account balance. Again, the RBNZ will be independent to pursue these goals.

Economists are leery of dual mandates because conflicts between two goals can create ambiguity about whether interest rates should rise or fall. Furthermore, it is impossible to use monetary policy (the OCR) to achieve a real economy goal such as higher savings at the same time as targeting inflation. For example, suppose the RBNZ lifted the OCR in order to achieve higher savings and a higher current account balance. Inflation would soon fall below target, and the RBNZ would have to reduce interest rates again. Or the exchange rate would rise, encouraging imports and nullifying any effect on the current account balance.

Under Labour's suite of proposals, these concerns don't apply. The Reserve Bank will be issued with an extra tool with which to pursue its extra goal. The Variable Savings Rate (VSR) could be used to target the savings rate or current account balance, while the OCR continues to be used to target inflation.

It is worth noting that Labour's proposal would amount to a dramatic widening of the Reserve Bank's purview. At present, the Reserve Bank mainly concerns itself with the value of money (inflation). Savings rates, the current account deficit and the VSR have little to do with inflation. Another agent of Government, such as The Treasury, could just as easily steward this area of government policy.

2. Compulsory KiwiSaver

KiwiSaver is currently a subsidised savings scheme. Employees contribute 3% of their income, employers contribute another 3%, and the Government throws in up to $521 per annum.

Labour proposes to make KiwiSaver compulsory, and to gradually increase the total contribution rate from 6% to 9%.

The idea is that compulsory KiwiSaver will increase the rate of national savings, that a higher rate of savings will reduce the average level of interest rates, and this will reduce the average level of the exchange rate.

On the first two points we agree – however, we suspect that the degree of impact would be small. On the third leg, we heartily disagree.

A compulsory savings scheme would no doubt achieve an impressive pileup of funds under management. But the effect on national savings would be more modest, because some people will rearranging their affairs to achieve the savings rate they want. For example, some people will repay their mortgages more slowly while accumulating KiwiSaver funds. These people would not have to alter their spending habits.

Extrapolating a little from the estimates of the Savings Working Group's 2011 report, moving from voluntary to compulsory Kiwisaver membership and increasing the employee contribution rate from 3% to 4.5% would result in 'new' household savings equivalent to 0.6% of GDP[1] – not nearly enough to close New Zealand's current account deficit of 3.3% of GDP. Australia has a compulsory savings scheme, and its current account deficit is similar to New Zealand's.

To the extent that compulsory KiwiSaver does increase national savings, New Zealand's chronically high interest rates would come down a bit, because a better-looking balance sheet would make us seem a less risky proposition in the eyes of lenders.

But reducing interest rates in this way would not necessarily affect the long-run average level of the exchange rate. Although the absolute return to a foreign investor would be lower, so would the perceived risk of the investment. Foreigners will not necessarily feel any more or less inclined to invest in New Zealand.

3. Variable Savings Rate

Labour proposes that the rate of compulsory contributions to KiwiSaver could be varied in order to help achieve the Reserve Bank's goals – the so-called Variable Savings Rate (VSR). At present Labour has not decided whether the RBNZ should be delegated this power wholesale, or whether the RBNZ should act as advisor to the Government. We would favour the former, because elected officials may be squeamish about actually pulling the trigger on what could amount to a reduction in voters' take-home pay.

The idea is that during spending binges, the VSR could be raised. Savings would rise and spending would fall, thus lifting the current account balance and reducing inflation pressure.

However, we suspect that the VSR would not be particularly powerful. Our back-of-the-envelope calculations suggest that a one percentage-point hike in the VSR would reduce household consumption by just 0.2% of GDP. And in terms of the impact on inflation, a one percentage-point hike in the VSR would be equivalent to an OCR hike of between 10bp and 15bp.

The Reserve Bank would have to be given latitude to vary the VSR very widely to make it relevant – a move which might prove unpopular.

Sometimes the Reserve Bank's goals would be in synch with one another, so the VSR and the OCR would unambiguously move in the same direction. For example, during spending binges like the mid-2000s the OCR and the VSR would both have gone up, and both would have contributed to countering inflation and to righting the current account imbalance. The overall increase in the OCR may have been less than what was actually experienced, if only a little.

Should conflict between the RBNZ's goals arise, the tools could be set in opposite directions. For example, if both inflation and the current account were below target, the Reserve Bank could set the OCR at a low level to boost inflation while setting the Variable Savings Rate at a high level to lift the current account balance.

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[1] Savings Working Group, "Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity", Final Report to the Minister of Finance, January 2011.

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