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Memo

To: Catherine Beard

From: John Pask

Date: 3 September 2012

Subject: **Monetary Policy**

Action Required: For Information

This paper provides some background to monetary policy in New Zealand, particularly policy tools which might (a) reduce the value of the $NZ, a number of independent voices have expressed concern at its apparent overvalued state, and (b) reduce its volatility, since this can impact on the ability to plan ahead.

It should be noted that the appropriateness of monetary policy in NZ (and its focus on achieving and maintaining price stability) has been raised numerous times and indeed has been the focus of various reports, included as an appendix to this paper. This paper does not deal with prudential requirements on banks (e.g. capital adequacy ratios etc) which are outside its scope but more relates to financial stability than to monetary policy per se.

Many of the concerns with exchange rates, volatility etc, are a result of developments and interventions in international markets, rather than any inherent weakness in NZ's monetary policy framework. The danger with trying to adjust policies to reflect international developments and knee-jerk international interventions is that monetary policy becomes more and more murky and risks damaging NZ's long-standing and transparent monetary policy framework. It would have obvious flow-on implications in terms of foreign investment and possibly the cost of capital.

A very good paper by the Governor of the Reserve Bank, Alan Bollard *"Learnings from the Global Financial Crisis"* (9 August 2012) provides some useful insights into the financial crisis and its impact on both monetary and fiscal policy settings:

"These extreme events have provoked us to re-think what is known and where economic research should focus, in some cases fundamentally. We had long known that banks that appear individually sound can be vulnerable to problems affecting the whole banking system, and that such problems can amplify economic shocks. But the crisis sharply accelerated the study of financial fragility, contagion, and instability nonetheless.

The crisis has also challenged us as financial regulators and monetary and fiscal policymakers. We are all working to understand, contain and repair the damage to financial systems, to economies and to governments' financial capacity. The policy choices in many areas involve difficult and uncertain tradeoffs."

The Governor's paper clearly indicates that there are no easy options or silver bullets and underlies the importance of examining policy tools and their implications from a wide range of perspectives. The danger with meddling with the Reserve Bank Act (or other Acts in response to short-term problems) needs to be clearly understood. It is important that any new tool is appropriate to the situation.

The Reserve Bank Act 1989

Before looking at some key monetary policy issues, just a little background on the Reserve bank Act 1989.

The Reserve Bank of NZ Act 1989 resulted in NZ being the first country to undertake explicit inflation targeting. There are now around 20 countries with such targets.

The Act focuses solely on maintaining low inflation, recognising the weakness in monetary policy attempting to achieve multiple and sometimes conflicting objectives. The target – an average CPI inflation band of 1-3% over the medium term - is contracted between the government and the RB Governor. There is scope for the RB to allow inflation to fall outside the target band without taking action, if over the relatively short term it is driven by factors beyond the control of the NZ economy e.g. oil price hikes as a result of war etc.

The Reserve Bank uses the Official Cash Rate (OCR) to set the price of borrowing as the main means of controlling inflation.

The Act requires the Reserve Bank to be transparent in its actions, by, for example, publishing a monetary policy statement at least every six months. The Finance & Expenditure Select Committee reviews the Reserve Bank's handling of monetary policy but the Act provides for independence from government intervention.

"The Reserve Bank Act of New Zealand (1989) recognizes the limitations of monetary policy in achieving multiple objectives, and specifies that the best possible contribution that monetary policy can make to the economy is achieving price stability.

New Zealand's choice of inflation measure is the headline Consumer Price Inflation. Some central banks look at some core measures of inflation by excluding certain volatile items such as petrol and energy prices. This way, they focus on underlying inflation rather than short-term contributors of inflation volatility. The PTA directs the Reserve Bank of New Zealand to focus on the headline CPI on average over the medium-term. This medium-term focus allows the Bank to look through any short-term volatility in inflation caused by oil prices, energy prices or any other one-off short-term variation. Therefore, with the medium-term focus, the difference between the headline and a core measure diminishes substantially."[1]

[1] Reserve Bank of New Zealand "Inflation Targeting: The New Zealand Experience and Some Lessons". Allan Bollard and Ozer Karagedikli, (19 January 2006).

General Issues Surrounding Monetary Policy in NZ

Concerns in respect to monetary policy settings have, over time, generally focused on four broad issues.

- How to support monetary policy achieving and maintaining price stability without the need to raise interest rates substantially – i.e. the need for monetary policy to "have mates"
- Issues associated with the Reserve Bank's sole focus on achieving and maintaining price stability, and the reasons, if any, for having multiple objectives for the Reserve Bank. e.g. employment, growth or other objectives
- Dealing with an over (or under) valued currency
- Dealing with volatility in the value of the $NZ.

Each issue is addressed in turn.

1. How to support monetary policy achieving and maintaining price stability without the need to raise interest rates substantially – i.e. the need for monetary policy to "have mates"?

You will recall that in the mid-2000s when the economy was growing strongly on the back of a world commodity price boom and a domestic-led recovery through strong household consumption (and rapid growth in borrowing), the Reserve Bank Governor, had to ramp up interest rates substantially to try and suppress inflation. Housing inflation, in particular, was strong and the effort to rein in this market meant that the entire economy, including the export sector, wore some of the pain.

As a result, several mechanisms were considered (by the Reserve Bank) to potentially take to pressure off interest rates.

The Reserve Bank looked at the following six options:

1. A tax on property for resale
2. Ring-fencing of losses
3. Improving the responsiveness of housing supply
4. Linking bank capital to cyclical risk
5. A discretionary loan to value ratio limit
6. A discretionary mortgage interest levy

Options 3 and 6 were considered to have the most potential, although the February 2007 report to the Reserve Bank and Treasury: *"Mortgage interest Levy, a Detailed Option,"* showed there would be significant issues associated with the later.

BusinessNZ for its part produced a publication: "OCR: The Sharpest Tool in the box" (2007) which looked at the pros and cons of a number of other measures that could potentially reduce the pressure on interest rates and therefore, the exchange rate pressures on exporters. In other words, providing the Reserve Bank with "some mates".

The BusinessNZ paper noted that some options were politically and economically unpalatable. Others had potential and were worthy of further investigation. However, as with the Reserve Bank's mortgage levy proposals, when one digs a little deeper, all have flaws. There is certainly no silver bullet.

The options outlined in the BusinessNZ publication, including pros and cons were:

- Put a lid on central and local government expenditure
- Improve the quality of regulation
- Adjust interest rates more decisively
- Increase competition in markets
- Improve productivity
- Improve communication with the public and key international markets
- Improve the responsiveness of housing supply
- Adopt a common currency
- Intervene in currency exchange market
- Lower interest rates
- Restrict use of fixed-rate mortgages
- Modify tax rates temporarily
- Introduce a capital gains tax
- Restrict bank credit lending
- Make immigrants pay

A link to the BusinessNZ paper can be found at: http://www.businessnz.org.nz/file/1195/OCR%20Magazine%20PDF.pdf

2. Issues associated with the Reserve Bank's focus on achieving and maintaining price stability

Winston Peters, in particular, has advocated for the Reserve Bank to focus on multiple objectives rather than solely focus on price stability. To this end Mr Peters has introduced a private members Bill to Parliament entitled: *"Reserve Bank of New Zealand (Amending Primary Function of Bank) Amendment Bill"* which essentially amends the primary function of the Reserve Bank to *"….implement monetary policy directed to the economic objective of maintaining price stability in the general level of prices while maintaining an exchange rate that is conducive to real export growth and job creation"*

Putting aside the technical problems of defining the above issues and times frames etc, the proposal would result in a fundamental shift in the role of the Reserve Bank and cause a strong degree of uncertainty in markets as to how the Reserve Bank would implement such a policy, given the potential for conflicting objectives at one time or another. As stated earlier, monetary policy needs mates to achieve price stability without adverse impacts. However, the most important (and arguably only) contribution that monetary policy can make to a sound functioning economy, is to focus on price stability. Many of the other factors outlined above in Mr Peters Bill e.g. export growth, employment etc are functions of wider government policy settings and the responsiveness of business to those policies and ultimately to markets for goods and services. To require the Reserve Bank to achieve these other functions is, quite frankly, to impose an impossible task on it.

Notwithstanding the above, section 9 of the Reserve Bank Act provides for an agreement between the Minister of Finance and the bank's Governor. Clause 4(b) of the current Policy Targets Agreement requires the Reserve Bank, when setting its monetary policy, to avoid unnecessary volatility in output, interest rates and the exchange rate, acknowledging that these are detrimental to economic welfare and may have adverse effects on economic growth.

Therefore, the Reserve Bank Act has one clear objective when setting monetary policy – price stability – BUT the Governor must be mindful of its impact on the factors referred to above when setting monetary policy.

While a requirement to consider factors noted in the Policy Targets Agreement does not pose a problem, changing the Reserve Bank Act to include new objectives - employment, the exchange rate, growth or any other such – would call into question the clarity of New Zealand's position.

3. Dealing with an over (or under) valued currency

A number of options have been put forward over the years in response to what are perceived to be over (or under) valued currencies.

Common proposals have included (a) intervening (buying and selling) currency, (b) markedly reducing (or increasing) interest rates (c) increasing liquidity (printing money) and (d) talking down the exchange rate.

These are briefly looked at below.

(a) Intervening on currency markets

The Government, via the RB, could trade in foreign exchange, selling NZ dollars in a bid to drive the dollar down. However:

- NZ is a small player in the world economy and could get taken to the cleaners by larger, sharper financial institutions overseas.
- NZ does not hold much in the way of reserves which could influence the direction of the dollar anyway. Huge capital reserves would be required.
- This would expose NZ taxpayers to considerable risk.
- If market participants thought government was going to intervene in the market then government could be expected to come to the rescue every time the dollar was considered to be artificially high; this would discourage businesses from taking appropriate actions to minimise their currency exposure.
- This could lead to greater intervention, eventually reducing confidence in the RB and monetary policy settings in NZ.

(b) *Markedly reduce (or increase) interest rates*

The RB could lower the official cash rate to reduce the attractiveness of NZ as an investment destination. However:

- To have a meaningful impact the OCR would need to be lowered substantially, by two percentage points or so.
- Interest rates in most other major countries are very low (close to zero) compared to NZ, so the margin between NZ and the rest of the world would have to drop substantially to have any real effect.
- Lowering NZ interest rates to close to zero would see nothing left in case the situation in Europe and the US really turns negative.
- Given that a number of factors influence the exchange rate, lowering the OCR might not necessarily result in a substantial long-term fall in the value of the $NZ relative to other currencies.

(c) *Increasing liquidity (quantitative easing)*

A number of countries (e.g. United States and Britain) have introduced policies such as "quantitative easing" which in essence means increasing the money supply. Essentially a central bank buys financial assets to inject a pre-determined *quantity* of money into the economy. A central bank implements quantitative easing by purchasing financial assets from banks and other private sector businesses with new electronically created money – hence often used term, "printing money". Such quantitative easing is usually undertaken as a last resort after interest rates have effectively come close to zero as a means of stimulating the economy.

Such moves can result in a lowering of a country's currency versus that of other countries. However, they are not without risks.

There is still debate internationally as to the impact of such policies and its long-term effects are uncertain. Quantitative easing may result in higher inflation than desired if the amount of easing required is overestimated and too much money is created. On the other hand, it can fail if banks remain reluctant to lend money to smaller businesses and households which would increase demand. In the context of traditional monetary policy tools, quantitative easing is quite radical and arguably should be used only as a last resort.

Alan Bollard, Reserve Bank Governor, in a paper entitled: *Learnings from the Global Financial Crisis" (9 August 2012)* stated: *"Unconventional policies can have unconventional side effects. We are currently observing spillovers from large economy QE impacting capital flows and exchange rate pressures in small open economies. Continuing exchange rate pressure is problematic for a country like New Zealand."*

(d) Talking down the exchange rate

The Government (or indeed the Governor of the Reserve Bank) could use speeches and statements etc to paint the $NZ as over-valued and suggest that it is 'not without options' for reducing the exchange rate. This, however, could add to uncertainty for investors or would-be investors, which would flow to other areas of the economy. In the past, such statements have generally been ignored by financial markets beyond the very short term.

4. Dealing with volatility in the value of the $NZ.

A couple of proposals have been put forward over the years by various parties aimed at reducing volatility and hence risk (apart from the normal well-used mechanisms such as hedging).

The two proposals are potential for (a) common currency and (b) A financial (or Tobin) tax on currency transactions to try and minimise speculation.

(a) Common Currency

Some people have advocated a common currency with Australia or the United States, believing New Zealand is too small to have its own currency and that by adopting another country's currency we could overcome some of the problems associated with fluctuations in the exchange rate. However, it is unlikely that this would be a panacea.

A common currency with Australia would facilitate trade in goods and services and be of major benefit to some manufacturers. It would certainly lower the transaction costs of doing business with Australia, and given that about 25% of New Zealand's trade is with Australia, would appear to make sense. Nevertheless, New Zealand also has significant trade with many other countries. Since so much trade is in US dollars, there would potentially be greater savings if New Zealand adopted the US dollar.

Tying New Zealand's fortunes to the Australian (or US) currency could result in monetary policy driven from Sydney, Melbourne or Canberra (or in the case of the US - New York or Washington). This clearly may not always be appropriate for New Zealand.

The Australian and New Zealand economies are still fundamentally different. For example, Australia has a much greater focus on mining resources. If their two currencies merged, currency movements would be likely to reflect the situation in Australia's main metropolitan centres, rather than what is happening in the wider New Zealand economy.

Where economies have divergent business cycles the costs of currency union would be greater. The New Zealand and US economies are at fundamentally different stages in the business cycle with New Zealand coming off a peak in growth, whereas the US is arguably at the bottom, or close to the bottom, of its business cycle.

It must also be remembered that there are many factors other than monetary policy that impact on interest and exchange rates. The degree of transparency in fiscal policy, the openness of an economy, regulatory policies, and overall transparency in government policy decision-making can all affect currency and interest rates.

(b) *Taxes on foreign exchange transactions (Tobin tax)*

Some people (and various political parties at one time or another) have supported the concept of taxes on capital inflows or on currency transactions (Tobin taxes).

James Tobin, an American economist awarded the Nobel Prize in 1981, suggested applying a small tax, say 0.5 percent, on the value of all foreign exchange transactions. He considered the tax would have negligible impact on foreign exchange transactions relating to payments for exports and imports and to long-term investment decisions, but would effectively prohibit all very short-term speculative transactions as a 0.5 percent tax on an overnight “round trip” transaction would be equivalent to a tax of 365 percent at an annual rate. This would effectively put a penalty on such short-term excursions into another currency.

Tobin was clear that he did not propose the tax as a method of raising revenue as he believed the majority of foreign exchange transactions, by value, would cease to occur if the tax were introduced.

Supporters of Tobin taxes argue that by trying to throw some sand in the wheels of the international market, or more formally, by reducing the volume of foreign exchange market transactions, exchange rate volatility would be reduced. However, there is no evidence to suggest this objective would be borne out in practice and those who have studied the Tobin tax are generally skeptical as to its merits for two important reasons.

First, the tax would be unlikely to have a major effect on the volume of foreign exchange transactions in New Zealand dollars unless it were to be applied by all countries where trading in New Zealand dollars can, and does, take place. In simple terms, for New Zealand to apply the tax would mean trading in New Zealand dollars in countries not subject to such a tax.

Second, and perhaps even more importantly, there is considerable doubt that reducing turnover in the foreign exchange market would have the effect of reducing volatility in the New Zealand dollar. Even if in theory all countries agreed to introduce a tax on all foreign exchange transactions (which is extremely unlikely) and the volume of transactions reduced significantly, there is no evidence that exchange rate volatility would also reduce. More likely, with less liquidity in the market, large individual export/import transactions, including investment and so on, would have a much greater effect on the exchange rate than is now the case. This would be the complete opposite from what supporters have in mind.

New Zealand is heavily dependent on the free flow of international capital while exporters need to be able to convert currencies in order to undertake international transactions.

The overall effect of any impediment, including increasing costs on foreign exchange transactions, would be to raise interest rates for all borrowers. Given New Zealand's high international indebtedness, such a move would simply make all New Zealanders worse off.

"Capital controls have been employed by many countries in the past two years in an attempt to control or restrain the upside of the exchange rate cycle. In October 2009 the Brazilian authorities imposed a 2% tax on foreign purchases of domestic bonds and equities. The IMF noted in August 2010 that this tax had some impact on slowing capital inflows. But the Brazilian real continued to appreciate and in October 2010 this tax was doubled to 4%, and then again raised to 6% two weeks later. The Brazilian real has appreciated by 38% against the US dollar over the past two years (to 1 January 2011) (The Economist, 2011). Ultimately, it is difficult to isolate the direct impacts of capital controls in the exchange rate because the counter factual is unknown." Source: NZ's Exchange Rate Cycles: Impacts and Policy – March 2011)

Most studies of the likely impact of the Tobin tax on financial market volatility have been theoretical. Some studies have concluded that a transaction tax could reduce volatility by crowding out speculators. On the other hand, other studies argue that a transaction tax would likely amplify, not dampen, volatility in foreign exchange markets by penalising informed market participants disproportionately more than uniformed ones. The result would be an increase in volatility.

Some critics of the Tobin tax believe the idea is based on a flawed view that trading – or speculation – is a bad thing. In reality trading helps the process of price discovery, makes markets work better, enhances liquidity, ensures resources are priced appropriately and is essential to oil the cogs of the global economy.

The Asia-Pacific Economic Cooperation (APEC) Business Advisory Council (of which NZ is a member) expressed the following concerns in an open letter to the International Monetary Fund (IMF) regarding Tobin and financial transaction taxes.

"We believe that imposition of a global tax is an inappropriate response and a further burden to industries, especially small and medium enterprises, and consumers in the wake of the global financial crisis. We also believe that the proposal under consideration would be harmful for a range of additional reasons, including the practical challenges of implementing any such tax." (2009)

In addition, the APEC letter made a number of other key points:

- APEC is supportive of reducing transaction costs. Taxation of transactions is directly counterproductive to this goal.
- Additional costs would likely impact on the world economic recovery as they would further reduce financing of business activity at a time when markets remain fragile.

- The tax would further weaken financial markets and liquidity, particularly in the case of illiquid assets.
- Effective implementation would be virtually impossible given the need for a global response and pressure on certain jurisdictions for “exemptions”.

APPENDIX Recent Reviews of Monetary Policy in NZ

Over the last decade there have been a number of reviews and discussion papers on monetary policy as specifically related to New Zealand.

Some key papers are:

1. *Independent Review of the Operation of Monetary Policy in NZ: Report to the Minister of Finance* (The Svensson Report - February 2001)
2. *Supplementary Stabilisation Instruments* Report to the Governor, Reserve Bank of NZ and to the Secretary to the Treasury (February 2006),
3. *Testing stabilisation policy limits in a small open economy:* the proceedings from a macroeconomic policy forum (Reserve Bank of NZ, October 2006).
4. *OCR: The Sharpest Tool in the Box?* (BusinessNZ, May 2007)
5. *Inquiry into the future monetary policy framework* (Report of the Finance and Expenditure Committee, September 2008)
6. *New Zealand's Exchange Rate Cycles: Evidence and Drivers* (New Zealand Treasury Working Paper 10/10 – December 2010)
7. *New Zealand's Exchange Rate Cycles: Impacts and Policy* (New Zealand Treasury Working Paper 11/01 – March 2011)

These papers are summarised below.

1. Independent Review of the Operation of Monetary Policy in NZ: Report to the Minister of Finance (February 2001)

In May 2000, the Minister of Finance invited Lars Svensson, an international expert on monetary policy from the Institute for International Economic Studies, Stockholm University, to review the operation of monetary policy in New Zealand. Terms of Reference were provided.

The Svensson report (February 2001) found with regard to the operational framework and management of monetary policy in pursuit of New Zealand's inflation target that *"….monetary policy in New Zealand is currently entirely consistent with the best international practice of flexible inflation targeting, with a medium-term inflation target that avoids unnecessary variability in output, interest rates and the exchange rate."*

The report emphasised the importance of effective communication to the efficient operation of monetary policy.

The report did find some weaknesses in respect to governance and accountability structures, for example, in relation to the appointment of directors, but these have since been remedied.

2. Supplementary Stabilisation Instruments Report to the Governor, Reserve Bank of NZ and to the Secretary to the Treasury (February 2006),

In November 2005 a team of senior Reserve Bank and Treasury staff was tasked with determining whether there might be useful tools, directly affecting the housing market and/or the market for residential mortgage credit, which could supplement the central role of interest rates in managing inflation. It was thought that if additional instruments other than the Official Cash Rate (OCR) were available to target the housing sector, these might alleviate some of the pressures on the exchange rate which at the time was adversely affecting the performance of the traded goods sector.

The Reserve Bank and the Treasury issued their report on the Supplementary Stabilisation Instruments project in February 2006.

Perhaps not surprisingly, the report concluded there is no simple or ready option (or options) that can be implemented easily, and provide large payoffs in the near-term.

The Reserve Bank looked at a number of options but particularly focused on six areas:

1. A tax on property for resale
2. Ring-fencing (of losses)
3. Improved responsiveness of housing supply
4. Bank capital linked to cyclical risk
5. A discretionary loan to value ratio limit
6. A discretionary mortgage interest levy

The table following summarises these options and the initial assessment. In short, the Reserve Bank suggested there might be merit in examining areas (3) and (6) in more detail but did not, after further though not exhaustive, investigation, recommend a discretionary mortgage levy.

	Option 1. Tax on property for resale	Option 2. Ring-fencing	Option 3. Improve responsiveness of housing supply
Description	Increased publicity and increased enforcement of current law (making gains on non owner-occupied properties purchased with the intention of resale liable for income tax). Other options: require reporting of all sales of property held for less than two years, or remove the exemption for owner-occupied property held for less than two years	Prevent operating losses on investment properties being offset against other income.	Measures to increase the speed at which new land and houses are able to be brought on to the market in response to evidence of rising demand.
Effects on cycle	Limited positive effects are possible (the more so, the more far-reaching the measures).	Likely to be quite limited (little evidence that cycles are more muted in countries that ring-fence).	Favourable, but hard to predict reliably how strong the effects would be. Any impact in dampening house price cycles would be offset, to some extent, by intensified pressure on the construction sector.
Other impacts (efficiency, stability, distribution)	Increased publicity and increased enforcement of existing law would have low efficiency costs. More far-reaching measures would involve greater administrative, compliance, and avoidance costs. Unlikely to be material adverse distributional impacts.	Immediate impact likely to be greatest on smaller and highly-leveraged participants in (and often new entrants to) the investment property market. Ongoing enforcement challenges and costs, and perhaps at the margin a reduction in the supply of rental properties. Represents a departure from the principle of treating similar investment activities similarly.	Should be generally favourable and, by improving affordability, should also have positive distributional impacts.
Implementation (enforcement, timing, legislation)	Heightening awareness of existing rules could be done quickly, although the legislative basis for any increased enforcement would need to be determined. A more extensive reporting framework would require legislation. Long-term effectiveness would be a challenge, with strong incentives to avoid any two-year reporting threshold.	Would require new legislation. Longer-term enforcement challenges, especially for more sophisticated and diversified investors.	Significant lags, because many constraints are likely to involve a wide variety of local authority rules. Understanding these and securing changes would take considerable further time and effort.
Initial Assessment	Could be merit in encouraging IRD to factor in broader cyclical considerations when allocating audit resources. Impact on cycle likely to be limited.	Not favoured. Little evidence that housing cycles are less marked in those countries that ring-fence than in those that do not.	Work in this area, building on what has already been commissioned, appears likely to be promising in the longer-term.

	Option 4. Linking bank capital to cyclical risk	Option 5. Discretionary loan to value ratio limit	Option 6. Discretionary mortgage interest levy
Description	Ensuring that bank capital requirements, under Basel II are better tailored to cyclical risks. Possible earlier modifications to Basel I, to link capital to loan to value ratios.	Comprehensive limit on loan to value ratio, imposed on all lenders and all loans secured by residential property. Able to be triggered at the discretion of the Reserve Bank, in response to periods of particular stress in the housing market.	Levy imposed on all loans, by all lenders, secured by residential property. Able to be triggered in response to periods of particular pressure in the housing market and when the gap between NZ and foreign interest rates is unusually large.
Effects on cycle	Likely to be quite limited. Main aim of the framework would be to ensure that banks have sufficient capital to cope with downturns rather than to dampen lending cycles.	Could be material, although would depend on correctly calibrating the scheme.	Could be material, by establishing a wedge between domestic mortgage borrowing costs and returns available to depositors.
Other impacts (efficiency, stability, distribution)	Limited adverse effects, as any changes would be designed to better align capital requirements with risk.	Poorly targeted and would impinge most directly on lower income and first home buyers. Could also constrain small and medium enterprise borrowing. Ongoing efficiency costs, heightened because it is a direct control.	Real resources costs devoted to implementing and maintaining the regime. Raises price of residential mortgage credit relative to other forms of credit, irrespective of relative risk considerations. Lowers returns to savers. Any increases in mortgage rates would fall most heavily on lower income borrowers and highly-geared new entrants to the housing market.
Implementation (enforcement, timing, legislation)	Basel II regime will not be in force for some time. Modifications to the existing requirements could be implemented quite quickly. If such measures had much effect on bank housing lending, disintermediation would be a concern because the existing powers affect registered banks only.	Would require new legislation. Long-term enforcement would rest with the Reserve Bank and would be a major challenge (especially for an instrument used infrequently). Particular difficulties may arise in avoiding offshore disintermediation.	Would require new legislation (with significant issues around ability to delegate authority to trigger the levy). Longer-term enforcement by IRD would face considerable ongoing challenges.
Initial Assessment	Shift to Basel II should ensure that over time capital requirements are better tailored to risk. Limited ancillary counter-cyclical benefits are also possible. Weaker case for changes to Basel I, although might have positive signalling benefits.	A direct control instrument and one which is relatively poorly targeted. This, together with the likely ongoing enforcement problems, suggests this instrument should not be developed further.	Better-targeted and with the advantage of being explicitly price-based. Enforcement would be a continuing challenge. Further work would be needed in a number of areas. In any overall assessment other discretionary demand management tools (including tax ones) beyond the scope of this review would desirably be considered.

3. Testing stabilisation policy limits in a small open economy: the proceedings from a macroeconomic policy forum (Reserve Bank of NZ, October 2006).

In early 2006, at the request of the Reserve Bank and the Treasury, four international academic experts and practitioners in macro economic policy visited New Zealand. Their brief was to examine the country's macro economic policy framework critically and consider whether alternative, possibly non-conventional, policy tools might be used to provide a smoother ride for the externally exposed sectors of the economy over the business cycle.

The report stated that:

"The overall conclusion that emerged is that the essential elements of New Zealand's macroeconomic policy framework are still fundamentally sound and remain appropriate. Furthermore, some fluctuations in the current account and some volatility in the exchange-rate and other relative prices are to be expected and are an important part of the process of adjustment to changing international and domestic events. Nevertheless, several suggestions to improve the way structural, fiscal and monetary polices interacted and impacted on the economy were raised and debated…"

4. OCR: The Sharpest Tool in the Box? (BusinessNZ, May 2007)

In May 2007 BusinessNZ released its own publication which examined a number of measures that could be used to help control inflationary pressures and hence reduce the pressure on interest rates as the sole mechanism for containing inflation – given flow-on effects on exchange rates.

The publication looked at 15 options that might reduce the pressure on interest rates as the sole tool for influencing monetary policy and thereby help to alleviate exchange rate pressures on exporters. However, most entailed significant risks. Certainly, there were no silver bullets.

What this report found was that effective policy solutions involve ensuring competitive markets by removing monopoly status from the provision of goods and services, reducing regulatory burdens which place unnecessary costs on businesses and individuals, and reducing fiscal stimulus by maintaining a tight control on government expenditure. Government expenditure should be targeted solely at clear cases of market failure. It also noted that issues relating to land availability and housing supply warranted further investigation.

The publication stressed that any moves to muddy the waters over who is responsible for monetary policy could result in reduced confidence in New Zealand's institutional structures. Therefore to maintain international credibility, if supplementary tools to support monetary policy were introduced, care would be needed to ensure the Reserve Bank retains control.

5. Inquiry into the future monetary policy framework (Report of the Finance and Expenditure Committee, September 2008)

In 2007, the Finance and Expenditure Committee conducted an inquiry into New Zealand's future monetary policy framework.

The Committee's terms of reference covered a range of areas including, amongst others: the causes of inflationary pressures, the effectiveness of current monetary policy in controlling inflation, the interaction of monetary policy and fiscal policy, and productivity issues.

The report was presented to the House of Representatives in September 2008 and made a number of findings.

Some key findings were:

- The importance of maintaining price stability as a vital component of a healthy and well performing economy
- Acknowledgement that New Zealand's monetary policy approach, emphasising central bank independence and inflation targeting, is standard among small, open, and developed economies
- Acknowledgement that at times of strong inflation pressures, the cost of maintaining price stability is often borne disproportionately by the export sector
- Acknowledgement that a range of economic factors and resource constraints have contributed to recent inflationary pressures and the speed with which monetary policy has affected inflation outcomes
- Acknowledgement that factors other than monetary policy – such as sustained improvement in trend productivity – play a key role in lessening the adjustments required to maintain low inflation over the medium term
- The evidence at the present time is not sufficiently compelling to support the pursuit of supplementary stabilisation instruments such as a mortgage interest rate levy, an interest-linked savings scheme, and other taxes that might complement interest rates in managing inflation.

6. New Zealand's Exchange Rate Cycles: Evidence and Drivers (New Zealand Treasury Working Paper 10/10 – December 2010)

This aim of the paper was to try and better understand the extent of New Zealand's exchange rate fluctuations compared with those of other countries, and what drives the New Zealand exchange rate.

The paper found that since the dollar was floated in the mid-1980s, New Zealand has experienced only a limited number of exchange rate cycles. On a trade-weighted basis, the country has had large exchange rate cycles but other relevant economies (e.g. Australia, the Euro Area, Japan and South Korea) have had similar large cycles.

On a short term basis, New Zealand's exchange rate fluctuates greatly but this is also the case with economies such as Australia and Japan.

The key factors impacting on the New Zealand exchange rate are the expected relative return on New Zealand dollar assets, including interest rate differentials between New Zealand and other countries. More fundamental drivers, such as export commodity prices and terms of trade, also affect the New Zealand dollar but other than exchange rate changes, the main driver over time has been, perhaps not surprisingly, developments in the domestic and global economy.

7. New Zealand’s Exchange Rate Cycles: Impacts and Policy (New Zealand Treasury Working Paper 11/01 – March 2011)

This paper explored the impact of New Zealand's exchange rate variability on the tradable sector together with policy options for dampening variability. It reached the fairly obvious conclusion that exchange rate variability in the medium term is likely to have a negative impact on the tradable sector but also found that the link between exchange rate variability and the performance of the tradable sector is not automatic; many factors are at work.

The paper found there are no easy or obvious ways to reduce exchange rate variability without imposing costs. It concluded, after examining alternative exchange rate regimes, that the freely-floating exchange rate regime is still the most appropriate for New Zealand.

The paper also examined ways of reducing exchange rate variability within the existing framework and suggested, consistently with almost all work undertaken on monetary policy in New Zealand, that it would be worthwhile giving further consideration to fiscal and housing policy.