Making fiscal policy more stabilising in the next upturn: Challenges and policy options:

- Paper by Anne-Marie Brook, NZ Treasury

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I'd like to thank the organisers of this conference for giving me the opportunity to participate in what is an important policy area for New Zealand. It's nice to think that even after being out of the country for ten years at least a few people think I might have something to contribute!

My challenge is to consider what perspective I can bring to the forum. When I look at the range of speakers, panel members and other discussants it seems I can most add value by thinking about the issues raised in the paper from the perspective of a financial market economist. While this isn't my only focus it is certainly something that I attempt to do in the comments that follow.

I will structure my remarks in the following way: first, I will directly consider some aspects of Anne-Marie's paper. In doing so I will draw on a couple of examples from my time in the NZ Treasury in the 1990s, as well as the way I thought about the role of fiscal and monetary policy in causing the blow-out in NZ's current account position from 2003. Second, I will comment on some work we have been doing at Deutsche Bank on Australia's current account position. Finally, I will provide some thoughts on whether lower interest rates necessarily mean a lower exchange rate – and whether the combination necessarily means a better current account position.

The Paper

RBNZ role

One change I wouldn't support is amending the Reserve Bank Act to *require* the RBNZ to explicitly comment on the cyclical dimensions of fiscal policy. In my view it is important to have a strong political consensus for an independent central bank with a primary focus on inflation and I think having the RBNZ continually making comments on fiscal policy runs the risk of eroding that consensus further for what is likely to be only a minimal gain in terms of the influence over fiscal policy settings.

The current account and fiscal policy

Before commenting further on the policy proposals, one key aspect of the paper that I think needs some additional work is on the question of the contribution that fiscal policy actually made to the current account blow-out from 2003.

If we look at the fiscal impulse measure then it only becomes pro-cyclical in 2006 and 2008 – and then only by less than 1% of GDP. Yet the primary damage to the current account position occurred well before then. To some extent the paper does acknowledge this by saying "the fact that this paper focuses only on the contribtutory role of fiscal policy should not be interpreted as downplaying the significance of these other drivers " (such as a "significant housing cycle, and high net immigration.") Still, the focus of the paper is very much on the impact of fiscal policy on the macro imbalances implied by the current account. Even if we accept the quite reasonable arguments in the paper that the fiscal impulse measure understates the easing in fiscal policy over the period in question it strikes me that the likely timing and size of the fiscal easing doesn't do a good job in explaining much of the deterioration in the current account position. This is not to say that a tightening of fiscal policy over this period would not have impacted on the overall policy mix. But I struggle to be convinced that fiscal policy played much of a role in contributing to New Zealand's "macroeconomic vulnerabilities" over this period. If we are looking to make policy recommendations aimed at lessening the impact of fiscal policy in NZ's macro imbalances then I think it important to make a stronger case that fiscal policy did contribute to those imbalances.

From my perspective as a financial market analyst what really stood out in the period from 2003 was the slow response by the RBNZ to the strong pick-up in the housing market and the rise in non-tradable inflation. In my view the delayed response by monetary policy exaggerated the rise in New Zealand house prices. In turn this had the impact of boosting household wealth and lowering the household savings rate. I think this was a major cause of the current account blow-out, not a high exchange rate brought about by the pressure fiscal policy was placing on monetary policy. Of course, I acknowledge that other commentators have noted that the deterioration in the household savings rate stopped in '02 – well before the peak in house prices. So it appears my explanation for the current account deterioration also needs work.

Still, to the extent that a tightening in fiscal policy might have persuaded the RBNZ to be even slower in lifting interest rates it is possible that it could have been counter-productive from a current account perspective if it led to even faster house price appreciation and a consequently greater reduction in the household savings rate.

Importance of institutional arrangements

I think the paper is right to focus on the institutional arrangements around fiscal policy as the best way to improve the conduct of policy. The Minister of Finance touched on the importance of this in his remarks. The political challenge of running large fiscal surpluses was brought home to me in my time as economic advisor to the Minister of Finance, Bill Birch, in 1993/94. Over that period the fiscal position of the Government shifted materially – from deficit to surplus. After years of expenditure constraint (can anyone remember the "mother of all budgets" in 1991) there was almost a collective cheer in the Beehive from everyone other than Mr Birch about the scope for spending that the shift to surplus provided. This emphasises to me that fiscal restraint is hard work and requires a robust set of institutional arrangements to be maintained.

Change to the PFA

It is from the perspective of institutional arrangements that I think the proposed change to the PFA has considerable merit. As noted earlier, a potential difficulty is the symmetry of the change. If weight is also given to fiscal stability on the downside then the fiscal sustainability aspect of the PFA is potentially watered down quite significantly. If an asymmetric stability objective is not possible then it may not be worth pursuing changes to the PFA given the inherent policy bias to limit downside economic outcomes in the near-term at the expense of longer-term success.

Stability funds

On the question of stability funds, I'd note that the NZ Super Fund effectively acts as an asymmetric stability fund. That is, it provides a parking spot for surpluses but can't be drawn down in times of deficit though the ability of the Government to alter the size of its contributions over the course of the cycle does assist the fiscal stabilisation objective in times of deficit (by freeing up funds that can be spent on more immediate priorities). An important component of arrangements surrounding the NZ Super Fund is that a temporary suspension of contributions means that "when contributions begin again, this required contribution will be higher than it would have been without the temporary suspension of contributions" (2009 Budget). This is a useful cyclically asymmetric feature of the fund.

In my view the NZ Super Fund represents a reasonable "second best" stabilisation fund that may actually be first best given that it avoids some of the problems of an explicit stabilisation fund. Perhaps its upside stabilisation properties could be improved by looking to more effectively 'lock-in' contributions from positive revenue surprises. This might be an area worth further consideration.

The current account from a savings imbalance perspective

One area I want to focus on a bit more is the current account from a savings imbalance perspective, referring to the Australian case where we have done some specific research – but I think the conclusions will be applicable to New Zealand.

In the past few years we've seen a significant improvement in Australia's current account position despite the fact the AUD has risen to its highest level post the float. Given that commodity prices are at record highs the improvement in the Australian current account balance might be seen as inevitable. But during the previous commodity boom from 2003 Australia's current account deficit actually got worse. Indeed, the historic experience is for terms of trade booms to cause deterioration in the current account position. This reflects the impact on domestic demand from the positive income shock.

So what's different this time? Critically, household wealth suffered a large negative shock through the global financial crisis and is now under pressure relative to income because of stable to falling house prices. As a consequence the household savings rate has jumped up sharply. This shift explains the improvement in the current account balance. Projecting forward we think there is good reason to expect the current account balance to improve further and for the deficit to remain at levels not seen for decades. This is despite a multi-decade high in the real exchange rate and our expectation that interest rates in Australia will remain relatively high compared to other countries. Indeed, it is this relatively high interest rate environment and the impact it has on passive household wealth creation (i.e. through asset price inflation rather than active wealth creation through savings) that is potentially critical to the improved current account position.

I highlight this shift to emphasise the importance of looking at the current account position as much from a sectoral saving/investment balance perspective as from the perspective of the exchange rate. This can potentially lead to quite different conclusions about the possible impact of specific policy measures on the current account deficit.

In the context of the current paper it is possible that low interest rates could actually lead to a bigger current account deficit even with a lower exchange rate if those low rates trigger an asset price boom that causes households to reduce savings materially. Just as Australia's current (and likely ongoing) mix of high interest rates and a high exchange rate is NOT preventing a sustained improvement in the current account position.