NEW ZEALAND AND THE WOODY ALLEN SYNDROME

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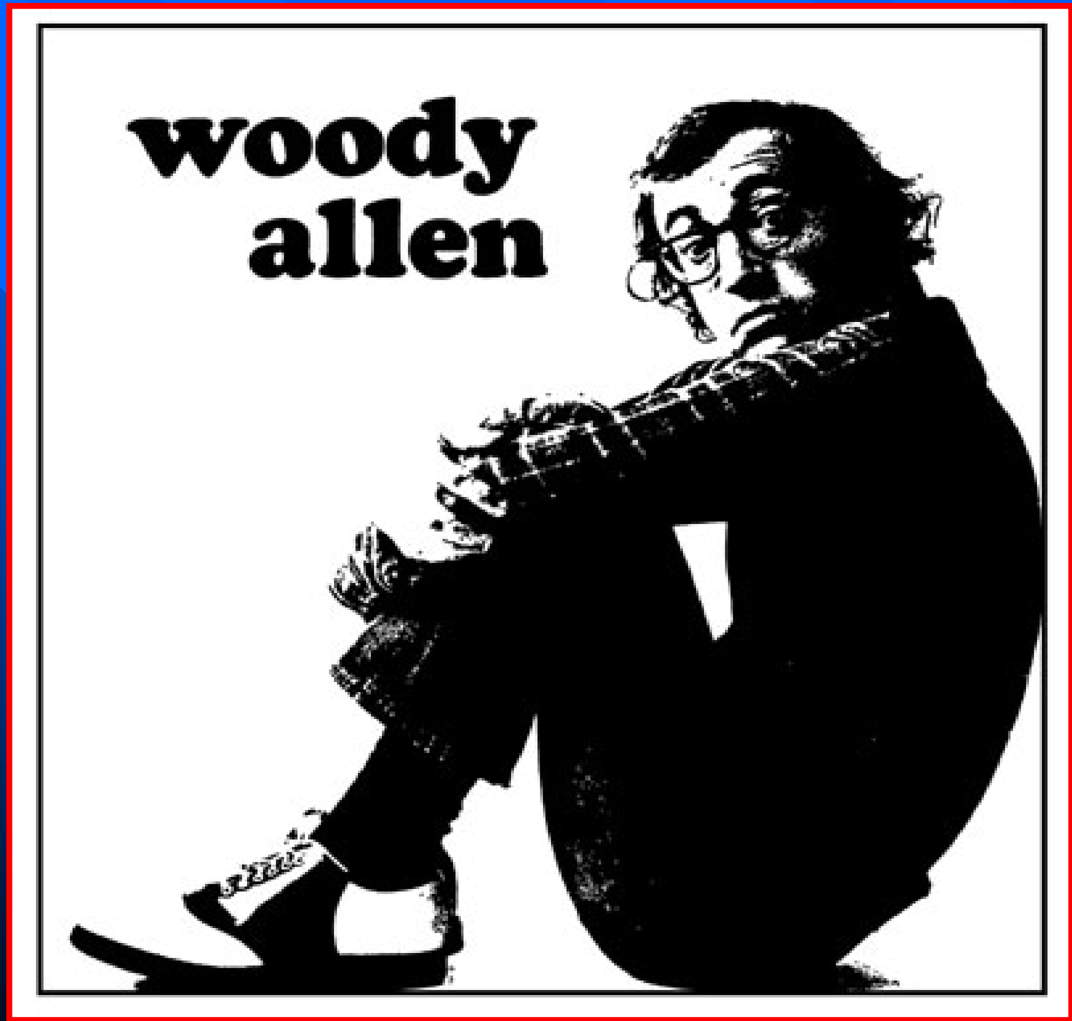
A certain volcano…

What does Woody Allen have to do with all of this?



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The "Unofficial-Official" Story

- The "policy mix" became perverse sometime in the mid 2000s: "*loose fiscal-tight money*"
- High interest rate differentials, high capital inflows, high debt, housing boom, strong currency, tradables stagnation, low savings, high current account deficit, increased vulnerability.
- How to solve all of this?: "Fix the policy mix," plus some additional measures.

Ratio of tradables to non-tradables GDP

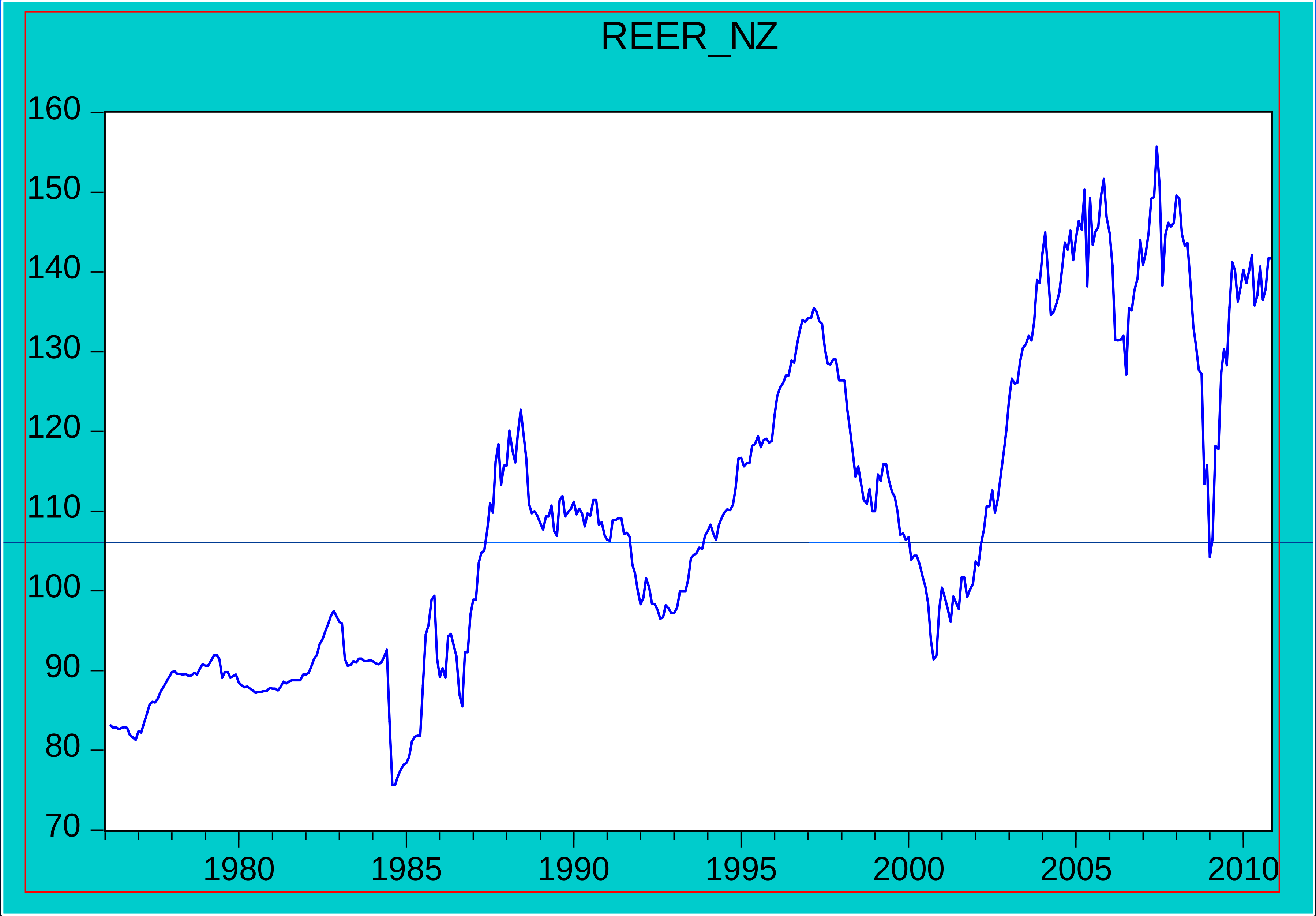
Assessment

- The “unofficial-official story” is a consistent and compelling narrative
- I agree with most of it, with some caveats, however:
  - We need to know more about certain relations before policy is implemented.
  - Doesn’t pay enough attention to Tinbergen’s and Mundell’s principles
  - Doesn’t ask which policy gives us more “bang for the buck”
  - Need to think in an “insurance framework”

Main conclusions

- Fiscal is very important, but New Zealand's problem is *not only fiscal*.
- As in the old high school exam, the correct answer is "***all of the above***"
- The competitiveness challenge requires micro reforms that increase productivity
- Savings enhancements require focalized policies: KiwiSaver, tax incentives
- Dealing with vulnerability requires insrance-type instruments

Real Exchange Rate Behavior in New Zealand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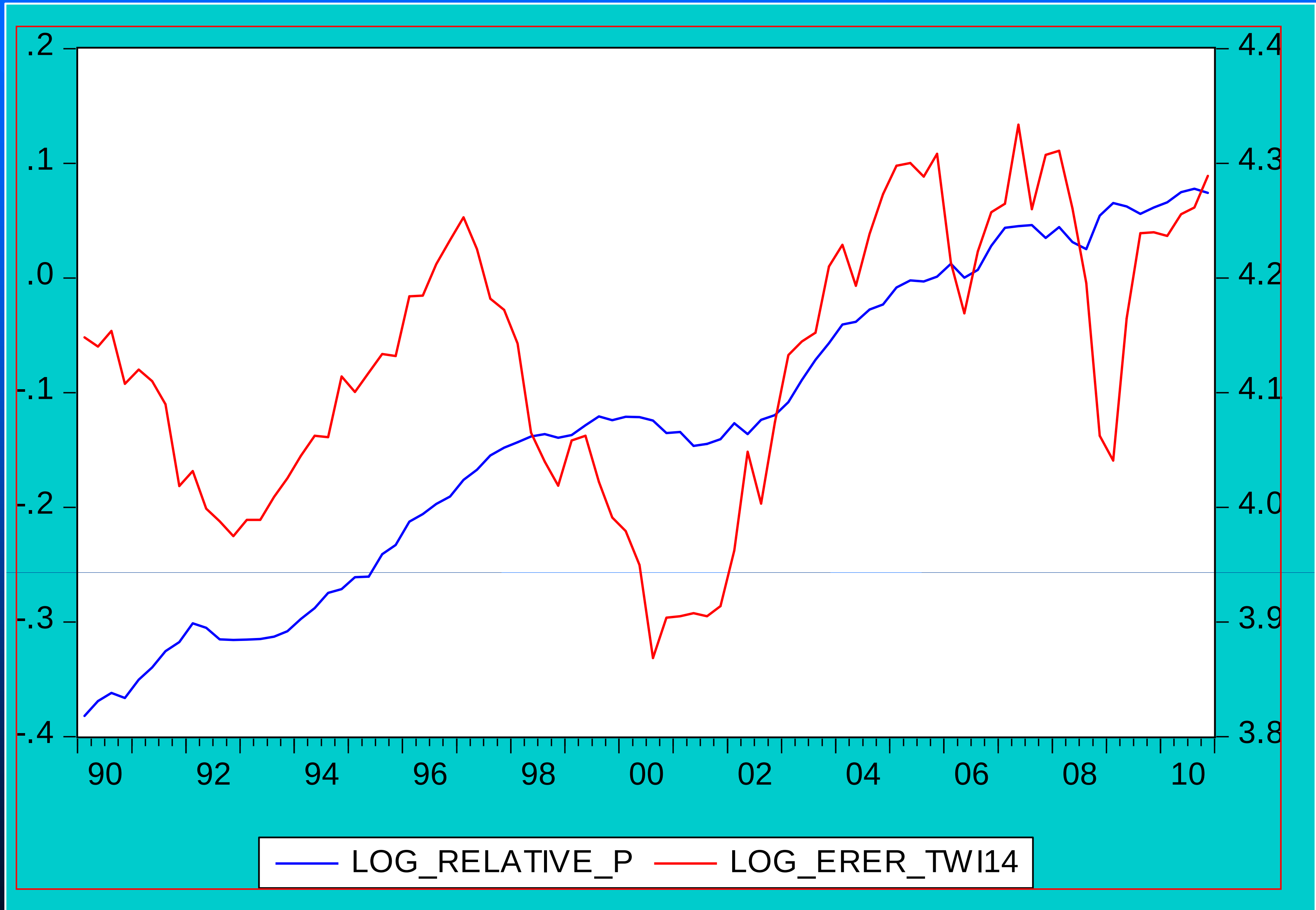

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Empirical Analysis

- The RER in New Zealand behaves similarly to other “commodity currencies”
- No evidence of “collateral damage” from “currency wars”
- Fairly rapid adjustment: in one year more than 50% of a disturbance is corrected
- Terms of trade positive shocks lead to appreciation, as expected.
- Increase in interest rate differential leads to appreciation, also as expected.

Exercise: Two shocks

- A negative terms of trade shock that reduces commodity prices by 50% would result in a long run weakening of New Zealand's trade-weighted RER of 16.7%.
- A reduction in interest rate differentials to a level equivalent to the (average) Australia-US differential, results in a long term weakening of New Zealand's trade-weighted RER of 8.6%.
- Combined shocks weaken RER by 23.8%.

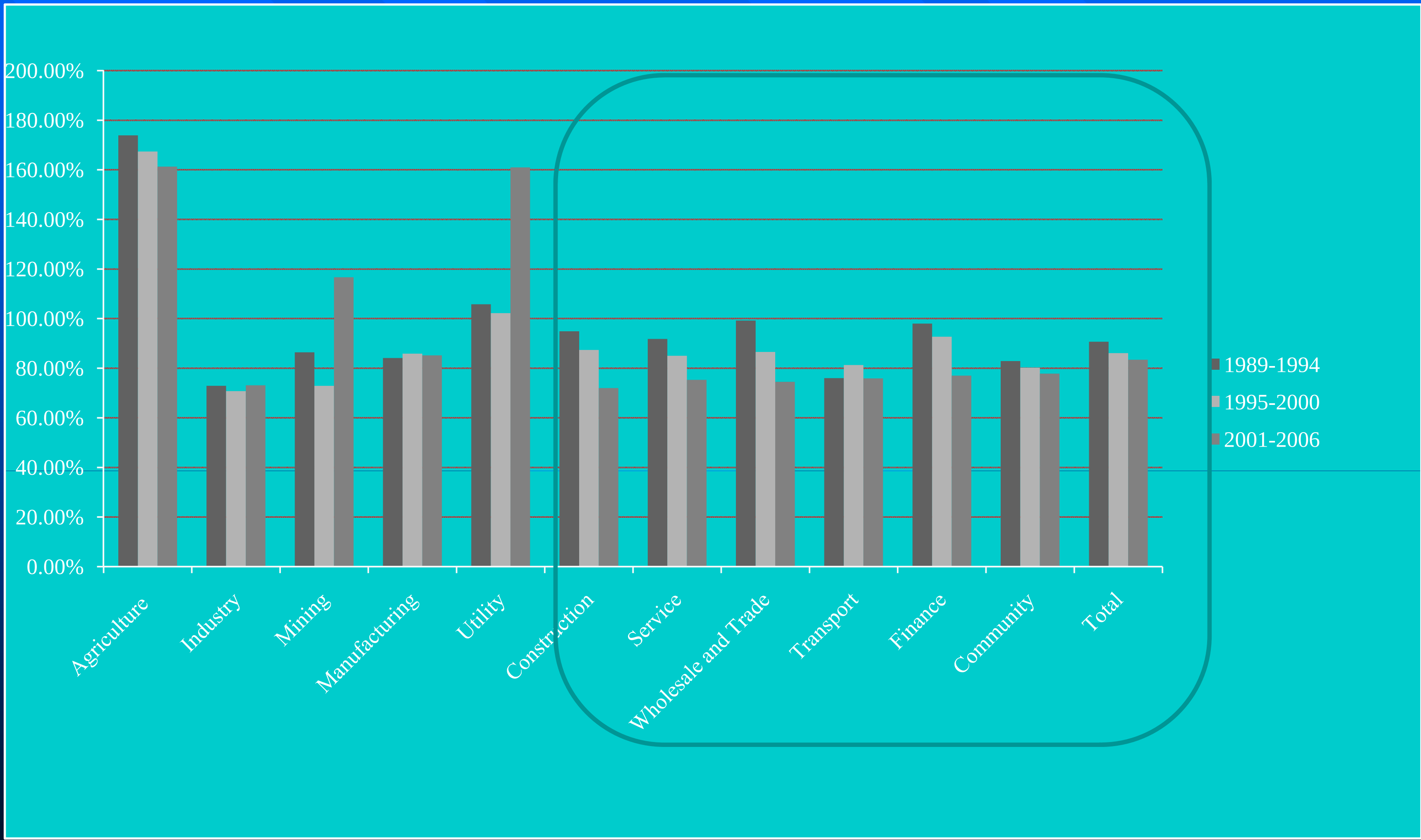
International Competitiveness and the Non-Tradables Sector

A new indicator: Effective Competitiveness Index

- Explicitly takes into account the fact that non tradables (including business and government services) are used as inputs in production of tradables

$$ECI_i = \frac{\left(1/E\right)\left(P_i - \sum a_{ij}\, P_j - \sum b_{ik}\, q_k\right) - \left(P_i^* - \sum a_{ij}^*\ P_j^* - \sum b_{ik}^*\ q_k^*\right)}{\left(P_i^* - \sum a_{ij}^*\ P_j^* - \sum b_{ik}^*\ q_k^*\right)}$$

Productivity levels compared to Australia



Example

- If non tradables in New Zealand have 70% of the productivity level in Australia ECI= - 0.15%
- So, bringing non tradables' productivity to Australia's level implies a *gain in competitiveness of 15 percentage points*
- Alternatively a real depreciation of 10% *improves competitiveness in 6.8 percentage points*

Some Reflections on Vulnerability

An insurance framework

- Useful to distinguish between
  - "*self insurance*" mechanisms – including the adoption of flexible policies --,
  - "*market insurance*" mechanisms,
  - and "*institutional insurance*" mechanisms.

Some options to consider

- International reserves
- Macro prudential regulations
- Taxes on capital inflows
- Bonds indexed to the terms of trade or the borrowing spread
- Preapproved swap lines from major central banks and/or FCL from the IMF

Conclusions