Comments on Phillip Lane: "*External Imbalances and Macroeconomic Policy in New Zealand*"

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Summary

- The paper focuses on *external* imbalances and largely accepts that NZ external imbalances as “too big” and policy should seek to reduce them
- Presents evidence on NZ external imbalance indicators (CAD, NFA, NIIP) compared to groups of European, Latin American and Asian countries
  - New Zealand is one of the higher EBs but, unlike others, has been the case over decades
  - Growth in EB measures in 2002-10 much less than comparators
  - NZ shift towards higher debt-to-equity composition of NFA
- Questions: do these matter?

Table 1: Evolution of Net Foreign Asset Positions

	2002	2007	2010	2002-2010
New Zealand	-84	-87	-87	**-3**
Euro Periphery	-48	-77	-101	-53
Emerging Latin America	-47	-24	-21	+26
Emerging Asia	-15	0	16	+31
Emerging Europe	-35	-65	-73	-38

Table 3: Net Foreign Debt and Net Foreign Equity Positions

	Net Debt			Net Equity			2002-2010	
	2002	2007	2010	2002	2007	2010	Net Debt	Net Equity
New Zealand	-55	-60	-63	-28	-27	-23	**-8**	**+5**
Euro Periphery	-39	-69	-91	-19	-26	-11	-52	+7
Emerging Latin America	-23	3	4	-24	-27	-25	+27	-1
Emerging Asia	0	27	36	-14	-27	-19	+36	-5
Emerging Europe	-2	-18	-25	-34	-47	-47	-23	-13

Summary – “Risk Assessment” and “Policy Issues”

- … Imbalances “too big” leading to: ‘several macroeconomic problems’
  - Distort economic structure (traded to non-traded) $\Rightarrow$ RER appreciation, slow growth
  - ‘stock of net liabilities drive up the real interest rate’
  - Exposure to a “sudden stop”
- Policy issues … ‘how should policy framework be further adapted?’ - monetary, macro-prudential, structural, **fiscal**
- Fiscal policy (define?): to ‘manage external balances’ …

  (i) Pre-emptive to stop growing EBs; (ii) to relieve EB/financial crises; (iii) framework of fiscal rules + monitoring ‘Council’

Comments …

Fundamental questions:

1. EBs – how big is "too big"?

   – what is the market failure (negative externality?) or policy distortion that needs correcting?

   – what is the risk (Sebastian's 'insurance framework' ⇒ premiums vs return)

   …. or more conventionally what does the macro/micro cost-benefit analysis look like?

2. If EBs "too big" – what is the best policy 'instrument' to hit the EB 'target'? (Tinbergen)
3. Fiscal policy has several components aimed at several targets

Responses …

- Fiscal policy (expenditure size and composition, tax levels and composition) should primarily be based on sound medium-term micro principles not short-term stabilization (Corden's "hierarchy of policy")

> *"For any given divergence… there is a first-best optimal policy or set of policies. Essentially this policy involves making the appropriate correction as close as possible to the point of divergence. But many policies may be conceivable, and one should be able to order them in a hierarchy from first-best to second-best and so on.*
>
> *… At each step down the hierarchy an additional by-product distortion is imposed…" (Trade Policy and Welfare*, OUP, 1997.)

- In NZ's small open economy with effective independent monetary policy and floating ER, I don't see a strong case for targeting fiscal policy at external imbalances … potentially large by-product distortions e.g. to efficiency and growth (… Mundell)

Responses …

- *But, where no* independent monetary policy, fixed exchange rates/common currency, fiscal policy could have larger 'adjustment' role targeted jointly at fiscal and external imbalances – as the only instrument available at the national macro level
- Some 'standard fiscal policy' principles can be expected to hold in NZ:
  - Given *some* degree of Ricardian Equivalence, increased government saving can be expected to increase national saving and, potentially, external imbalances
  - Fiscal balances should avoid undermining the counter-cyclical role of monetary policy (not the same as being actively counter-cyclical)
  - Public debt levels need to abide by inter-temporal GBC

So, … where does this leave conclusions on Philip's fiscal policy advice?

- "External risks call for a low medium-target for public debt"

Agree, but NZ already has, even after GFC. (Fiscal buffers ARE important)

- "an *activist* fiscal approach to limiting the scale of net capital inflows and the use of fiscal instruments to facilitate external adjustment"

Disagree (other than government abiding by its medium-term GBC – as ever!) We don't know what the optimal scale of external imbalances is.

- "a formal fiscal framework … an institutional commitment to maintaining a low target public debt and running a counter-cyclical fiscal policy…"

Agree on better institutional mechanisms for avoiding discordant fiscal and monetary policy settings . But 'independent fiscal council' – I doubt a CBA would support for NZ. Unlike RBNZ it would/should never have independent policy-setting mandate.

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