RESERVE BANK OF NEW ZEALAND

Comments on:

Policy Responses to Exchange Rate Movements
by Laurence Ball

Bernard Hodgetts

Key messages from paper

- Monetary policy can stabilise aggregate output, but not at the sectoral level
- A coordinated mix of monetary and fiscal policy might help to stabilise sectoral output
- ... and it could offer greater scope to cushion vulnerable sectors (eg non-commodity exports) from commodity export shocks

My comments

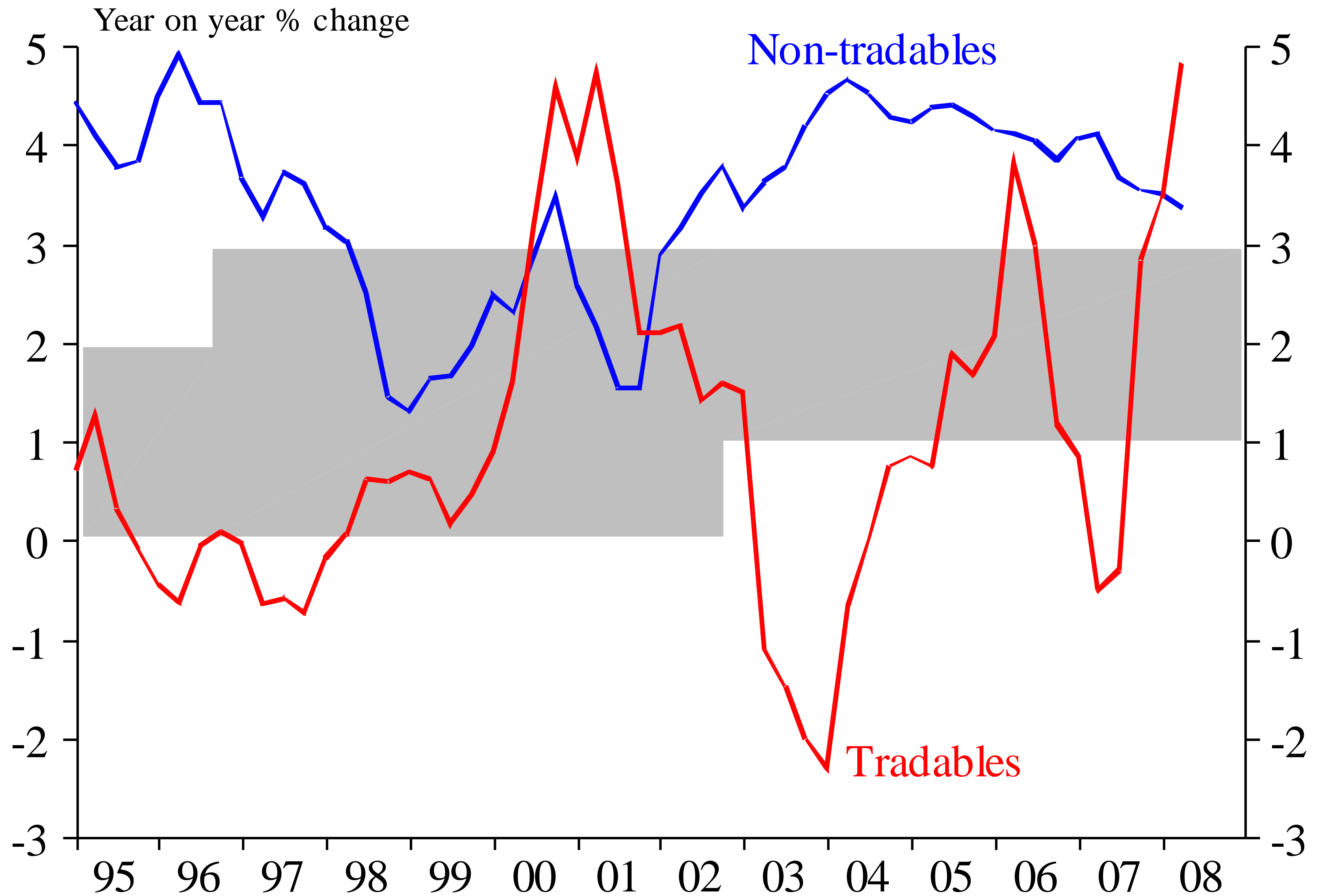
All the usual caveats around stabilisation come to mind

- Policy lags, coordination issues, identification problems …
- … worse when you have two instruments and focusing on ‘sectors’ as well as the aggregate
- But we are not necessarily talking ‘fine-tuning’ here – this is about doing a better job dealing with large, pervasive shocks.

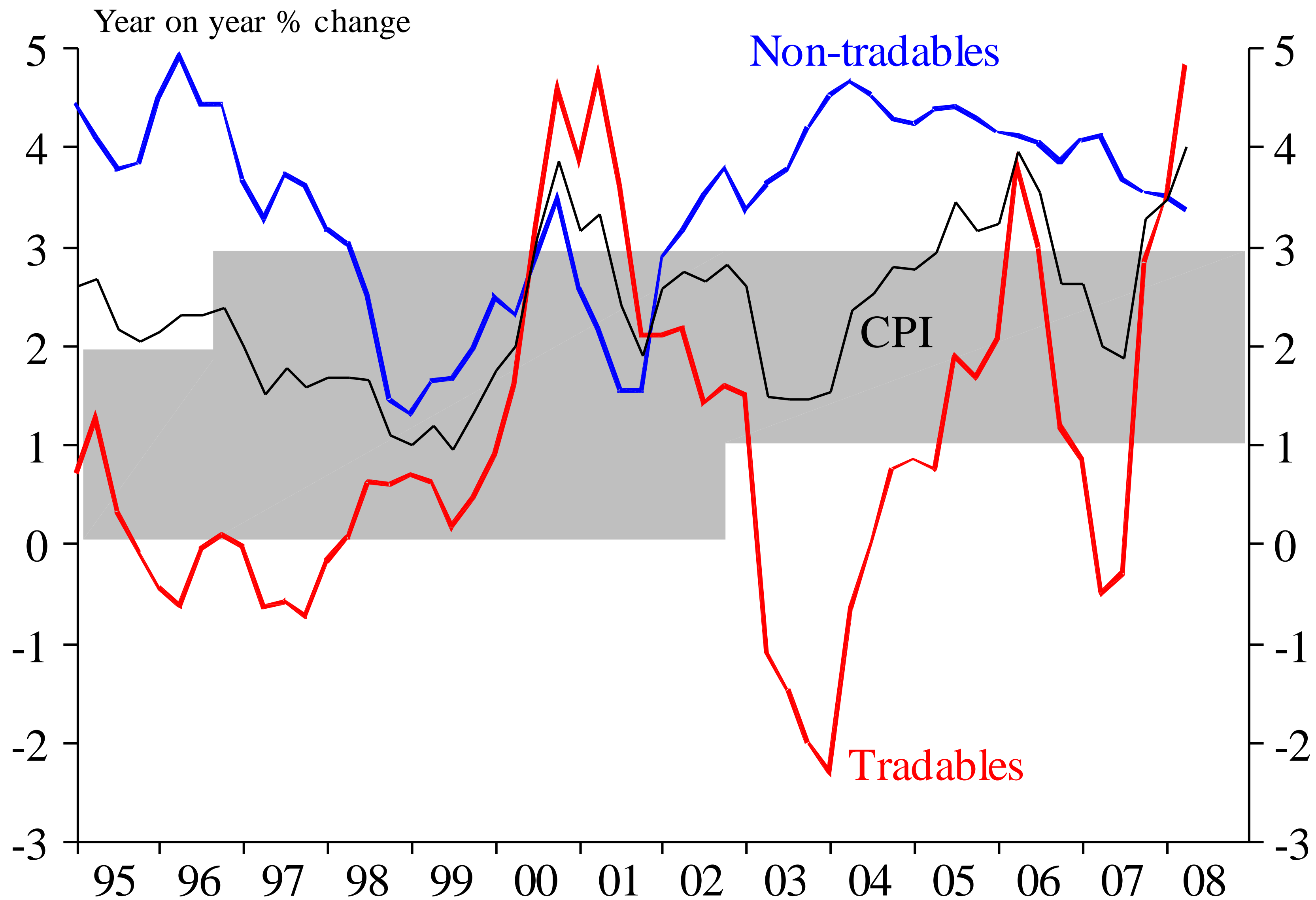
Might greater focus on sectoral output stabilisation enhance inflation targeting?

- Sectoral output volatility can be reflected in sectoral inflation rates (New Zealand experience)

New Zealand: tradable and non-tradable inflation



New Zealand: tradable and non-tradable inflation



Might greater focus on sectoral output stabilisation enhance inflation targeting?

- Sectoral output volatility can be reflected in sectoral inflation rates (New Zealand experience)
- Divergent sectoral inflation rates – even if they offset in the aggregate – could still hinder inflation targeting efforts eg.
  - Inflation expectations formation
  - Could fuel asset price bubbles

Alternative stabilisation instruments

- New Zealand: concerns that export sector has borne the brunt of monetary policy adjustment
- A lot of thinking in recent years about alternative stabilisation instruments that could assist monetary policy
- Have considered fiscal instruments
  - eg variable rate of GST
  - Governance and constitutional conventions seem to be key sticking points …
  - But we have concluded they could be useful

Dealing with Commodity shocks (1)

- How much can we cushion non-commodity exporters from commodity export shocks?
- Consider sharp commodity price rise
  - Undertake monetary easing to lower exchange rate
  - Monetary easing will amplify commodity shock
  - So very large fiscal contraction could be required to completely stabilise domestic economy and stabilise non-commodity exports!
- Large distributional effects likely to be unacceptable
- But may still be able to make meaningful difference at the margin

Dealing with Commodity shocks (2)

- Distinction between permanent and transitory commodity shocks may be important
- Very hard to tell the difference
- How much would you want to stabilise sectoral output in the face of a permanent commodity price shock that shifts the real exchange rate?

Dealing with Commodity shocks (3)

- Broad-based shift in taxes may not be best approach to stabilisation when commodity exporters face a windfall
- Larry suggests government could trade commodity futures with producers, with government taking long position.
- Might be better if government creates the market but goes short (with international consumers taking the long positions).

End