

# NZCPR Research

NEW ZEALAND CENTRE FOR POLITICAL RESEARCH

JANUARY 2009

## DON BRASH'S COMMENTARY ON BRYAN GOULD'S "RESCUING THE NEW ZEALAND ECONOMY"

*This is a letter written by Dr Don Brash, the former Governor of the Reserve Bank and former National Party leader, to a colleague "John" commenting on the arguments presented in the book "Rescuing the New Zealand Economy" by the former Vice Chancellor of Victoria University and former British Member of Parliament, Bryan Gould.*

Dear John,

You suggested that Bryan Gould's book, "Rescuing the New Zealand Economy", was quite persuasive to the non-economist and asked if I would write a commentary/rebuttal. I had to steal myself to read it(!), because most of the stuff Gould writes irritates me greatly. However, I have now read it, and am happy to make some comments.

### **Gould correct in some things**

At the outset, I should say that Gould is correct in some of the things he says.

- He is right to worry about the decline in New Zealand's relative standard of living over recent decades. As you know, that relative decline has been a major preoccupation of mine for many years, and was the main motivation for my entry into politics in 2002.
- Although not all economists would agree with me, I also think he is right to worry about the very large current account balance of payments deficit New Zealand is running (despite the strong export prices we've enjoyed until recently), and the very large external liabilities we have run up as a consequence of the fact that the balance of payments has been in deficit ever

since about 1974. If my memory is correct, New Zealand's ratio of net external liabilities to GDP (over 90%) is now greater than any other developed country in the world with the exception of Iceland (though Iceland's problem is substantially more serious, both because its net external liabilities to GDP are much higher than ours and because their gross external liabilities are enormous – and that matters when the gross assets turn to custard, as has happened).

- Again, not all economists would agree with me, but I think he is right to worry about the big cyclical swings in the exchange rate which make investing in the tradable sectors (exporting and competing with imports) appear much more risky than investing in non-tradable sectors (such as property). Having said that, when my colleagues in the Reserve Bank studied the biggest appreciation in the “inflation-adjusted trade-weighted exchange rate” which New Zealand experienced in the nineties (from early 1993 to late 1996, an appreciation on that basis of some 29%) and compared it to the biggest appreciation experienced by other countries, I was surprised to discover that the inflation-adjusted exchange rate appreciation which we had suffered was of the same order of magnitude as that experienced by the United Kingdom and vastly less than that experienced by Japan. (The appreciation from October 2000 to the middle of 2008 appears to have been relatively larger, which is ironic because it started shortly after Michael Cullen asked me, in the Policy Targets Agreement of late 1999, to keep inflation under control without causing undue fluctuations in interest rates, exchange rates and output.)
- I think his critique of Muldoon's economic policy is almost entirely valid.

**But New Zealand not the victim of an “extreme monetarist experiment”**

But his fundamental thesis – that New Zealand has been the victim of an “extreme monetarist experiment” – is completely wrong, and he is wrong also in a very large number of other respects as well.

On the “extreme monetarist experiment” line, he ignores the fact that every developed country in the world has a central bank which conducts monetary policy to keep inflation low and stable by manipulating a short-term interest rate lever. Yes, some central banks operate under a legislative mandate which requires them to keep an eye on economic growth and employment also, but that is because in many cases the legislative mandate was passed into law at a time when policy-makers believed that monetary policy *could* actually deliver several different objectives, including low inflation, economic growth, full employment, and so on. No economist that I know of now believes that – monetary policy certainly does affect economic growth and employment in the short-term, but in the longer term only directly affects the inflation rate. Because low inflation is beneficial for economic growth (it helps people make sense of prices), monetary policy makes its best contribution to growth by keeping its focus on delivering low, stable, inflation. Every central banker that I know of believes that.

Of course, when low inflation has been achieved, as it was in New Zealand in 1991, it will be very hard or impossible to tell whether a central bank is targeting only inflation or whether it is also targeting economic activity because the paradigm within which most central bankers operate sees inflation falling when economic activity falls below the economy's capacity to produce and rising when economic activity rises above that capacity. Hence, a central bank targeting low inflation will, once low inflation has been achieved, also be seeking to keep economic activity close to the economy's capacity.

Gould makes much of the "independence" of the Reserve Bank of New Zealand, and implies that that independence is different from that in other developed countries. That too is nonsense. Before 1989, when the Reserve Bank of New Zealand Act 1989 was passed, there were only two models of the relationship between government and central bank – the Bundesbank model of "complete independence" (enjoyed by the Bundesbank and a small number of other central banks, most notably the Federal Reserve Board in the US and the Swiss National Bank) and what I call the "old Bank of England model", where the central bank made recommendations about monetary policy but all decisions were made by the Minister of Finance/Chancellor of the Exchequer. Gould clearly prefers that latter model.

But one of the characteristics of monetary policy is that it has a short-term effect on economic activity and a longer-term effect on inflation. So it is tailor-made for cynical politicians, who can use it to stimulate economic activity in the short-term (say, near the beginning of an election year) knowing that the inflation consequences of an easing of monetary policy will not show up until after the election is over. The best recent example of that in New Zealand – and the example that prompted Roger Douglas to ask Treasury and the Reserve Bank to work out how to "Muldoon-proof" monetary policy after he became Minister of Finance in 1984 – was 1981, when Muldoon ignored repeated advice from the Reserve Bank to tighten monetary policy in the lead-up to the election that year, only to "discover" a big inflationary problem in 1982 after the election was won.

Roger Douglas's request to Treasury and the Reserve Bank led directly to the 1989 legislation in New Zealand, which created a third model of the relationship between central bank and government. In that model, the central bank is neither completely independent nor completely the creature of the Minister. Instead, the Minister agrees with the Governor, in writing and in public, the inflation rate which the Governor is to deliver during the Governor's term of office, and then holds the Governor accountable for delivering that (subject to "shocks" which the Governor can't reasonably be expected to offset, such as a change in GST or an abrupt change in international oil prices).

Contrary to Gould's assertion that the New Zealand arrangements are undemocratic, I think they are much more democratic than those in, say, the European Union or the United States (where there is no involvement at all by Parliaments or governments in setting the inflation target). To be sure, the Reserve Bank Governor

makes the technical decisions about how best to adjust interest rates to achieve that agreed target, but the target is effectively set by the Minister (technically in an agreement between Minister and Governor on the Governor's appointment, but it is a fair bet that the Governor would not be appointed if he was not willing to accept the Minister's desired inflation target). It's no surprise that this model has been very attractive to democracies like New Zealand, and has since 1989 been copied by Canada, Australia and the United Kingdom (by the Labour Party of which Gould was a senior member).

Gould uses the term "extreme monetarist" to describe not just the monetary policy arrangements in New Zealand but also the whole reform programme undertaken by the Labour Government of the eighties and the National Government of the early nineties. It is a very poor use of the term, and in any case incorrectly implies that the New Zealand reform programme of the eighties and early nineties was totally out of line with what other countries were doing at the same time. Certainly, the New Zealand reforms were implemented more rapidly than in most other developed countries, and in some respects were more extensive than in other countries, but in part that was because, in 1984, we were further behind the international policy consensus than most other countries were. It wasn't for nothing that David Lange referred to New Zealand's being run like a Polish shipyard! We reduced quantitative import restrictions fairly quickly, but most other countries had done that earlier. We reduced tariffs over a six or seven year period, but other countries had done that earlier. We floated our currency, but other countries had done that earlier. We privatized some government-owned enterprises, but other countries had done at least some of that earlier also. We introduced a GST, but many other countries had a (very similar) VAT. I can't think of any component of what Gould calls the "extreme monetarist experiment" which had not already been undertaken in at least several other developed countries.

### **Other misleading or incorrect assertions**

Gould makes so many assertions in his book that to reply to all of them would require me to write another book, and I don't intend to do that. But let me give you a flavour of some of the statements which I found particularly misleading (in the approximate order in which I came across them in reading his book).

- At several places, starting on page 8, he asserts that monetary policy has become ineffective in combating inflation. Nobody would deny that it takes longer for monetary policy to deal to inflation when a significant fraction of home mortgage lending is at fixed rates, but it is nonsense to assert that monetary policy no longer works to control inflation. Germany has long had an overwhelming predominance of fixed rate lending, but nobody doubts that the Bundesbank was able to control inflation in Germany over several decades. New Zealand achieved a rate of inflation below 2% in 1991 and except for very minor breaches in the mid-nineties the rate of inflation was kept consistently within the agreed inflation target until very recently. Yes, the CPI is outside the target range now, but that is the result of the Reserve

Bank being a bit too slow to tighten in 2005 and of the sharp increase in international oil prices in the middle of this year. The inflation rate is projected to fall back inside the target over the next year or so.

- At page 18, Gould asserts that “monetarist discipline was enforced. Public services were pared back. Social security benefits were limited. Taxes for the well-off were cut.” Although on the same page he concedes that “much of this was long overdue”, he contends that the reforms were “an expression of an ideological position that was totally unfamiliar to New Zealanders”. The comment is a good example of Gould’s equating the whole reform programme with monetarism, which is of course a nonsense. Few countries in the world are more “monetarist” in the strict sense of the word than Germany, and yet Germany has long had a pervasive social security system and comprehensive legislation protecting the rights of employees. And yes, the top personal income tax rate was cut drastically in New Zealand (as it had been in the UK and the US earlier) but at least in New Zealand’s case the cut in that top personal rate was accompanied by the closing of almost all the “loopholes” which the affluent had used prior to the cut in the top rate – the loopholes which had encouraged “Queen Street farmers” to invest in deer farming, kiwifruit orchards, films, and musicals in the West End, to say nothing of the personal superannuation schemes. Several high income New Zealanders have told me they paid more in income tax *after* the cut in the top tax rate than they had done *before* the cut because of the closing of all the loopholes.
- On page 19, Gould asserts that “the wealthy suddenly became, in New Zealand terms at least, super-wealthy” as a result of the reform programme. It is undoubtedly true that some New Zealanders became rich as a result of the reform programme but many of those who were wealthy before the reforms became a good deal *less* wealthy as a result of the reforms. Prior to the reforms, the wealthy were primarily large-scale farmers, highly-leveraged commercial property owners, and manufacturers producing behind a total prohibition on imports. As a result of the reform programme, both interest rates and the exchange rate rose sharply and protection against imports was drastically reduced, with the result that farmers were put under severe financial stress (you will recall the well-publicized suicides), many property companies collapsed, and formerly highly-protected manufacturers were forced to move production offshore or otherwise make drastic changes in their operations. Large numbers of those who had been wealthy before the reforms became a good deal less wealthy because of the reforms.
- Because Gould needs to argue that all New Zealand’s problems stem from the reforms begun in 1984, he needs to assert that, until the reforms began, New Zealand’s living standards were similar to those in Australia. Hence, on page 24 he states that “in 1984, Australian and New Zealand living standards were broadly comparable”. I don’t know what numbers he was using to back up this statement, but I know that when I was in Parliament my research staff told me that in 1971 after-tax wages in Australia were, on average, about the same as after-tax wages in New Zealand, while by 1984 after-tax wages in Australia were about 20% above those in New Zealand. In 1999, after-tax wages in Australia were still about 20% above those in New Zealand, so that the reform programme, while not able to make a dent in the lead which

Australia achieved over the period between 1971 and 1984, at least enabled New Zealand to hold its relative position vis-à-vis Australia over the period between 1984 and 1999. That was in itself a rather remarkable achievement, given that that 15 year period included a period of very slow growth in New Zealand as we both reduced production in those industries no longer protected from imports and reduced inflation (reducing inflation from a high level to a low level almost always causes a temporary slowdown in growth), and another period when we were hit by two successive droughts and the Asian crisis (which had a more drastic impact on New Zealand than on Australia). In other words, I think the evidence suggests that, even taking the relatively short period of years after the major reforms were completed in the early nineties, the reforms were successful in enabling New Zealand to broadly keep pace with Australia. By contrast, since the Labour Government began to unwind some of the reforms in late 1999 the gap between after-tax wages in the two countries has begun to widen again, and is now in excess of 30%.

- On pages 24 and 25, Gould discusses our performance in terms of growth in GDP per capita and in terms of GNI (gross national income) per capita. Curiously, on page 26 he then asserts that “the true worth of New Zealand’s GNP growth is undermined by the fact that much of it – poor as it is – is accounted for by the increase in our population since 1984. The increase in output per head, in other words, is even lower than the national output figure would suggest”. This is a very odd statement given that he was talking about per capita GDP and GNI growth on the previous two pages.
- He is correct, however, on page 26 when he asserts that over the period 1990 to 2005 our productivity performance has been poor. He chooses his years carefully however. Had he chosen the period from 1993 to 1999, he would have found that growth in productivity in New Zealand was markedly higher than it had been previously, and comparable to productivity growth in Australia, whereas in the period after the election of the Labour Government in 1999 productivity growth slowed markedly.
- On page 27, he notes that manufacturing output in New Zealand “is on an unmistakable downward trend”, falling from 19% of GDP in the early 1990s to 15.1% in 2006. He blames that in large part on a rise in the exchange rate, which in turn he blames on the “extreme monetarist experiment”. But two points. First, there has been a marked decline in manufacturing output in most developed countries over the last two decades, largely as the result of the emergence of a vast amount of manufacturing output from China over the same period: it would be surprising indeed if Chinese output had *not* caused some reduction in the relative importance of manufacturing in all developed countries. Second, in this section at least he implies that the exchange rate has risen steadily over the period as a result of the “extreme monetarist experiment”. But of course the exchange rate has gone both up and down over the period between 1990 and the present; moreover, even had New Zealand had a fixed exchange rate over that period the *real* (or inflation-adjusted) exchange rate would have moved up and down over time, as exporters discovered to their cost before the New Zealand dollar was floated in March 1985. (The Hong Kong dollar has been fixed against the US dollar

since 1983. But because inflation in Hong Kong has been markedly higher than in the US, Hong Kong's *real* exchange rate has appreciated quite strongly over that period, with the result that the majority of Hong Kong's manufacturing sector has moved across the border into China.)

- At several places, starting on page 28, Gould makes a number of assertions about foreign direct investment in New Zealand.
  - He claims, for example, that we have sold off "a huge proportion" of our assets, "including a large chunk of our infrastructure". What was he thinking of? Roads are entirely owned by the public sector. Three of the four major power generators are owned by the government. The electricity grid is owned by the government. The public sector owns almost all the ports in their entirety. After a brief period of foreign ownership, the government again owns the railways. The government owns most of the country's largest airline. Yes, the government sold the Bank of New Zealand and the Post Office Savings Bank to Australian banks, but the banking sector has long been dominated by Australian-owned banks.
  - Gould asserts that "most of the 'investment' (that multinational companies) make in our economy is in fact a direct purchase or takeover of an existing asset; in such cases, no new capacity is created". But even if it is true that much foreign direct investment involves the acquisition of an existing company (and this ignores very substantial post-acquisition investment in some cases), he can only make that statement if he believes that New Zealanders selling to foreigners squander the proceeds of their sale in riotous living, and themselves invest none of the proceeds in new capacity.
  - Later, on pages 40 and 41, he claims that "the rapid increase in overseas ownership of the New Zealand economy has meant a substantial loss of control by New Zealanders over their own economic fortunes" and notes that "a society that has handed over the most important decisions to the 'free' or untrammelled market is not well placed to ensure that wider considerations than immediate market advantage can, where necessary, take priority". But, as I'm sure Telecom and Vodafone would be more than willing to attest, foreign ownership doesn't prevent the New Zealand government from enforcing new rules and regulations on the telecommunications sector, and all those companies struggling with the effective ban on genetic engineering, or with the problems caused by the Resource Management Act, will be happy to attest that the suggestion that New Zealand has a "free or untrammelled market" is a figment of Gould's over-vivid imagination.
- At the foot of page 28, Gould notes that "our need to offer high interest rates to attract the short-term 'hot money' from overseas required to fund our (balance of payments) deficit adds substantially to the size of that deficit, which then begins to multiply itself." But short-term interest rates in New Zealand, determined by the Reserve Bank, are not driven by our need to attract "short-term 'hot money' from overseas": our short-term interest rates have been high relative to those in many other countries, and that has probably played some part in attracting money from overseas and pushing up our exchange rate, but the *purpose* of those rates has been to restrain

inflation, not to attract 'hot money'.

- On page 31, Gould attacks the "aggressively free-market approach to regulating operators in financial markets... The faith displayed in the market to regulate itself and to provide adequate protection for those who operate in it is touching but, sadly, all too often misplaced." Gould's book was published in 2008, but it is not clear when its writing would have been concluded. He was undoubtedly thinking of the large number of finance companies which have failed in New Zealand over the last year or so. He may have been unaware at the time of writing how many very large – and highly regulated – financial institutions would require bailing out in the second half of 2008 in the United States and other major developed countries. By contrast, the finance company failures in New Zealand will have caused losses to their investors, even in a pessimistic scenario, of less than 1% of the assets of the banking system in New Zealand. That doesn't look like a serious failure to me, nor one warranting a heavy-handed approach to financial sector supervision.
- At page 35 and elsewhere, Gould makes a lot of the increased disparity between those on low incomes and those on high incomes over the period since the mid-eighties, and claims that New Zealand has moved from "being one of the more egalitarian societies in the developed world to being one of the most unequal" (page 36). I'm a bit dubious about some of the numbers, but that is probably a broadly accurate statement. Moreover, income disparities are going to get greater still if *average* incomes in New Zealand fall further and further behind those in countries to which skilled New Zealanders can readily move. Those who can most easily move to higher incomes overseas are, almost by definition, those with marketable skills. To retain them in New Zealand, we will increasingly have to pay to our most skilled people "lifestyle-adjusted incomes" broadly equivalent to those they could earn in higher income countries. Since our *average* incomes are, by assumption, going to continue well below those in higher income countries, payment to skilled people of incomes broadly equivalent to those they could earn abroad means that income disparities will inevitably increase further unless we can start reducing the gap between our average incomes and those in other developed countries.
- On page 38, there is a gross caricature of New Zealand society. Somebody reading that section could well be excused for assuming that income tax in New Zealand is highly regressive and that scarcely anybody is supported by taxpayer-funded welfare payments. Of course, the reality is very different: New Zealand has a steeply progressive income tax, with those on low incomes paying little or no tax at all and 50% of the total income tax paid by a small minority of top income earners. Gould asserts that "the whole point of 'free-market' economics is that it does produce inequality; that is its purpose". On page 85 he asserts that "social *in*justice is exactly what is intended" by the advocates of a free market. "Free-market economics" may or may not produce inequality (compared with what alternative?), but I've yet to meet the advocate of a free market who does so *because* it will increase income inequality or *because* it will create social injustice.

- At page 42, Gould seems to realise that there have been some benefits brought by the economic reforms of the eighties and early nineties. He notes that "it is undoubtedly true that the New Zealand economy is now much better attuned to meet the interests of the consumer than it was", and goes on to note "the rise of the tourist industry, the civilizing effect of the wine industry, the improvements in retailing, the advent of the Internet, and the openness to the rest of the world so that a much wider range of goods from around the globe is now available". He comments that these "valuable improvements" "have occurred over the period of the 'reforms', even if not actually caused by them". Not actually caused by them? Come on Bryan: most of those improvements were directly caused by the reforms!
- On pages 50 and 51, there is a discussion of the relationship between interest rates and the exchange rate. Gould reflects the common view that all things being equal "higher domestic interest rates will... attract an inflow of short-term money... from overseas", with resultant upwards pressure on the exchange rate. Fair enough, though all things are *not* always equal. For example, the year 2000 began with the OCR at 4.75%. By October that year, the OCR was 6.5%, and yet the New Zealand dollar reached its all-time low at less than US\$0.39 that month. Certainly, US interest rates were similar to New Zealand's rates at that time, but Japanese interest rates were, even then, close to zero. Every time the OCR was increased that year, the New Zealand dollar fell against the US dollar, and the central banks of Australia and the European Monetary Union had a very similar experience that year. Moreover, he asserts that a rising exchange rate "is likely to have very damaging effects on our producers". I accept that, but what Gould seems to ignore is that what matters to our producers is not what is happening to the nominal exchange rate but rather what is happening to the *real* exchange rate, as I have already noted. With a stable nominal exchange rate, the real exchange rate appreciates whenever New Zealand's local inflation rate is higher than that in the countries with which we trade, so that *refraining* from tightening monetary policy in the hope that that will avoid an appreciation in the nominal exchange rate doesn't solve the problem of an appreciation in the real exchange rate if not tightening monetary policy allows local inflation to rise above that in our trading partners.
- On page 52, and again at pages 80 and 116, he claims that the Reserve Bank is beholden to the banking industry. Thus, at page 80 he says "the 'independent' central bank is in no sense objective or neutral. It is a bank. Its main clients are banks. It is staffed by bankers. It takes a banker's view of its responsibilities. It can be relied upon always to put the interests of the financial establishment ahead of those operating in the rest of the economy." This is unadulterated nonsense. Yes, my predecessor as Governor, Sir Spencer Russell, had been a banker but during Sir Spencer's term as Governor most of the monetary policy decisions were made by Dr Roderick Deane, who was a professional economist and central banker and who had never been a banker prior to leaving the Reserve Bank. I had certainly been in both investment banking and in commercial banking prior to becoming Governor but I had also been the managing director of the New Zealand Kiwifruit Authority and continued to own an orchard producing kiwifruit for export. I was acutely aware of the pressures on the export sector when I first

became Governor in 1988 (I had been aware of growers committing suicide because of their inability to service their mortgage). Moreover, to the best of my knowledge only one other person on the Bank's payroll had ever been involved in banking. And the present Governor has never been a banker. Gould's accusation is grossly defamatory to a group of highly professional and totally dedicated people.

- Also on page 52, Gould asserts that with the central bank running monetary policy, "virtually nothing is left of macroeconomic policy". Again this is an extraordinary statement. Macroeconomic policy is generally agreed to include both monetary policy and fiscal policy. Certainly, the technical decisions required to reach the politically-determined inflation rate are made by the central bank in the New Zealand situation, but nothing about that requires a particular level of government spending or a particular level of taxation. In most of Europe, the European Central Bank determines monetary policy without any regard to political influence at all, but that does not determine the level of government spending or the level of taxation in any country using the euro – although the countries which use the euro have agreed to limit the extent of their deficit spending.
- On page 53, Gould states that "all experience shows that deflation is inimical to growth, investment and productivity". For the sake of the argument, I'm happy to concede that point even though there is some evidence that the period between 1870 and 1900 saw a gradual decline in prices in several large economies despite, or because of, rapid growth in both productivity and total output. But the implication of the statement is that New Zealand has actually experienced "deflation" in the last two decades. In fact, consumer prices have never fallen in New Zealand at any time since 1984 – or indeed for many decades prior to that. And although it would of course be great if we had managed a still higher rate of economic growth than was in fact the case over the period from the early 1990s to 2007, our growth was pretty respectable over that period and unemployment declined steadily over the entire period (with only a brief interlude for the Asian crisis/droughts in 1997/98) to the point where it was the lowest in the developed world. That hardly sounds like a disaster!
- On page 54, Gould asserts that "an economy in which interest rates are held high over a considerable period – such as our economy has been – is by definition an economy that is hostile to the interests of the creators of new wealth. This is because high interest rates advantage the existing holders of wealth to the detriment of those who want to borrow money for investment in new productive capacity". There are two points here. First, it is hard to argue that interest rates have been, in any fundamental sense, "too high". If they had been, New Zealanders would have been falling over themselves to save and reluctant to borrow. But as Gould himself admits elsewhere, New Zealanders are world champion dis-savers. We haven't been saving too much and borrowing too little – we have done the reverse because we have seen interest rates as very attractive to borrowers. Yes, interest rates have seemed high compared with consumer price inflation but people don't compare interest rates with consumer price inflation (except when they are complaining that interest rates are too high): they compare interest rates

with *expected* inflation in the property market, and when they do that interest rates seem attractively low. Second, while high interest rates may suit “the existing holders of wealth” who have all their wealth tied up in bank term deposits, most of the wealthy that I know are not in that situation: they run businesses or they own property, and for them high interest rates are a pain in the neck.

- On page 55 there is a related point. Gould notes that “the higher cost of money in inflationary times hits domestic borrowers and businesses, but a large proportion of that higher amount is paid to non-residents.” Certainly, because New Zealand interest rates have seemed too low to encourage New Zealanders to save sufficient to fund the borrowing appetite of other New Zealanders, banks have had to fund the shortfall by borrowing in overseas markets. But this overseas borrowing by banks covers only about 40% of their total lending, so that the majority of the increased interest payments made by banks goes to New Zealanders.
- The chapter entitled “Why are interest rates no longer effective to control inflation?” asserts, as I have noted previously, that raising interest rates is no longer effective in controlling inflation, and indeed may even make inflation worse. Gould uses some rather strange arguments to contend that businesses in the non-tradable sector of the economy treat interest as a cost to pass on to hapless consumers, and notes that inflation has been consistently higher in the non-tradable sector than in the tradable sector. That is true but has more to do with the fact that the non-tradable sector is heavily dominated by the prices charged by government entities facing minimal competitive pressures and with the fact that companies operating in the tradable sector almost by definition have higher rates of productivity growth than companies in the non-tradable sector. If raising interest rates no longer works to control inflation, it is indeed strange that every central bank in the world uses them for that purpose.
- On page 65, Gould says that “the decision by the Governor of the Reserve Bank to raise interest rates yet again, and then again, at a time when large parts of our productive industry were flat on their backs, was not a statement of confidence on his part in his policy prescriptions, or even a calculated gamble; it was an admission of failure and despair.” Gould of course makes no reference to the fact that at the time inflationary pressures were growing markedly, unemployment was at an all-time record low, and every employer in the country was screaming out for staff.
- On page 71, Gould has another of his caricatures of the position of those who favour a free market. He claims that they fail to recognise “that the modern market could not operate without man-made laws – the law of contract, the rules protecting property, the limited liability company, the principles of insurance, the whole paraphernalia of courts and lawyers and law enforcement.” I’m truly surprised that a man who was for some years Vice Chancellor of one of our major universities should make such a claim: not even the most extreme believer in the power of the market would deny the need for *any* of those things being provided by government.

- I have already discussed Gould's attack on the independence of the central bank, and his claim that it is a major derogation of democracy. If it is, it is a derogation of democracy common to every other developed country in the world. But there are a few other points he makes in the chapter discussing the independence of the central bank.
- He claims, at the foot of page 78 and the top of page 79, that inflation in New Zealand had fallen significantly "in line with world-wide inflation, long before the move to an independent central bank... The Reserve Bank has done little more than keep New Zealand inflation in line with inflation rates in most of our major trading partners. Once again, the main influence seems to have been prevailing inflation rates internationally, rather than anything very remarkable about domestic policy". He totally fails to acknowledge that the Reserve Bank was directed to get inflation down without reference to the Minister of Finance soon after the election of the Labour Government in 1984 – in other words, the Bank had de facto independence more than five years prior to gaining de jure independence when the 1989 Act came into force early in 1990.
- Astonishingly, he also asserts, on page 79, that "the whole of our economic policy (and much of our policy in areas such as health, education and environment as a result) has been subordinated to the single goal of controlling inflation". That claim is, quite frankly, ludicrous, as anybody who has looked at what successive governments have done in, for example, health spending can see.
- On page 80 he claims that New Zealand government spending accounts for the second-lowest proportion of GDP in the OECD. I'm not sure where he got his information from because, according to the OECD data that I have seen, that is nowhere close to the truth. But even if his claim were correct, all it would clearly establish is that countries with independent central banks have a wide range of policies in terms of the size of their government sector, making a nonsense of his claim that having an independent central bank somehow involves handing over the entirety of macroeconomic policy to "unelected officials".
- He claims on pages 80 and 81 that the Reserve Bank, because of its sympathetic view of anything to do with the banking industry, has "deliberately averted its gaze from the factor that really is the primary cause of inflation – the huge rise in bank lending". No, the Reserve Bank has been acutely aware of the huge rise in bank lending in recent years but the decision to implement monetary policy by varying the *price* of bank credit rather than by rationing its availability reflects a world-wide move by central banks away from quantitative rationing of credit in favour of using price (the interest rate) because of the problems always created by quantitative rationing in the financial sector (the problem of deciding who is eligible to get access to the limited quantity of bank credit and the problem of disintermediation).
- On page 85, when Gould discusses the implications of "free-market policies", he lists one of those consequences as a "rigorous policing" of public spending.

Nobody who has seen what has happened to public spending under the recent Labour Government will believe that claim: government spending rose substantially between 1999 and 2008.

- Gould has a whole chapter devoted to the possibility of a currency union with Australia, and what is extraordinary is that he clearly doesn't understand the concept. He seems to imagine that we would simply declare all New Zealand dollar prices to be in Australian dollars, effectively revaluing upwards the New Zealand dollar by some 20%, and he rightly notes that such an upward revaluation would be very damaging to our export and import-competing industries. But of course if a currency union were to occur, New Zealand dollar prices would need to be converted to Australian dollars at some agreed exchange rate, and it is inconceivable that the agreed exchange rate would be parity. There are pros and cons of a currency union with Australia, some of them economic and some political, and I gave quite a major speech on the subject about nine years ago. But Gould's argument is a rather silly straw man demonstrating only that he doesn't understand the issue.
- On page 105, Gould states that "interest rates should not be used to manipulate the exchange rate as a counter-inflationary instrument. The currency should be allowed to find its natural, market-determined level, so that our prices are competitive in international markets, including our own. This would allow us to sell our production at the same time as balancing our current account..." It is not at all clear how Gould imagines this would be achieved. Every country which has a central bank has a domestic interest rate and inevitably, whatever that interest rate is, it will have an effect on the exchange rate. So what the "natural, market-determined level" of the exchange rate is goodness only knows! (On this, he echoes the views of Phil Verry, whom he quotes approvingly. Mr Verry was always demanding of me when I was Governor that I let the "market" determine the short-term interest rates, and he seemed unable to understand that every country has short-term interest rates determined in large measure either by their own central bank or, if they have adopted the currency of some other country, by that other country's central bank.) On the same page, he envisages "an economy where credit for investment (as opposed to consumption and housing) was relatively inexpensive and available, where the exchange rate was monitored to preserve and improve competitiveness, and where incentives were provided for investment and productivity gains, would not only free itself from many of the current burdens (including the ticking time bomb of an unsustainable current account deficit). It would also optimize its counter-inflationary strategy". It is clear from this, and from comments on page 115, that Gould envisages a much greater use of quantitative controls on bank lending, with officials deciding on the allocation of lending by purpose. Most countries have tried this in the past; most have now abandoned such involvement in the allocation of bank credit.
- The chapter on the use of fiscal policy is an important one and I agree with Gould that fiscal policy can and should be used to ease the pressures on monetary policy (and thus on the exchange rate). But his touching belief that the Fiscal Responsibility Act guarantees that Ministers of Finance will always put the economic interests of the country ahead of their own political interests

should have been destroyed by Dr Cullen's willingness to increase government spending strongly – much of it in ways which increased consumer spending rather than investment spending – notwithstanding the inflationary pressures in the economy until recently. And it is surely naive to believe that "decisions on tax levels and spending plans could be made promptly, could be carefully targeted, could be implemented without delay and would therefore be much more effective, and more quickly so, than the slow-acting and poorly focused use of interest rates". It is quite unclear what kind of "spending plans" could be implemented quickly (certainly not infrastructure investment) and equally reduced quickly (certainly not redistributive spending). And while governments have often been quick to reduce taxes, they have typically been much more reluctant to increase them. As I have argued elsewhere, I believe there would be merit in giving the Governor some tightly constrained ability to vary the excise tax on fuel as a way of increasing the tools in his anti-inflationary armoury in a way which avoids affecting the exchange rate, but I don't believe for a moment that governments would be willing to actively manipulate tax and spending programmes at a frequency to parallel the central bank's ability to move short-term interest rates.

- On page 113, Gould asks an extraordinary question in the context of his chapter on creating a more effective central bank. "If the Reserve Bank is to achieve defined goals in its handling of monetary policy, why should those not include real economy targets such as improved output and living standards, and perhaps environmental targets such as environmental sustainability?" I find it extremely depressing that, decades after it became accepted wisdom that monetary policy *cannot* have lasting effects on "output and living standards", let alone on "environmental sustainability", we are still debating this issue. I have no problem at all in agreeing that improving living standards is much more important than whether inflation is 2% or 5%. But unfortunately I have yet to see the slightest scrap of evidence that a 5% inflation rate (or a 10% inflation rate) would produce a sustainability higher growth in living standards. The notion that other central banks have a wider mandate is essentially illusory, as I have noted previously, and if "general welfare" is measured at least in part by levels of unemployment, it is entirely unclear why Gould thinks we have done less well than, for example, the countries of Europe.
- On the same page, he notes that in New Zealand monetary policy decisions are formally made by one person, the Governor. That's true, and it has been a subject of much debate. When the Swedish economist, Lars Svensson, reviewed the monetary policy framework for the Labour Government in 2000, he recommended that decisions be made by the Bank's Monetary Policy Committee, and I understood the logic of that. But the Bank's Board and the Treasury strongly recommended that the single decision-making structure be retained, to ensure that somebody could be held to account if the inflation rate fell outside the agreed target without due cause.
- On pages 117 and following, Gould notes that we've had an extraordinary boom in housing in recent years. True, but the same is true in all English-speaking countries and many of the countries of Europe as well. It is certainly not a phenomenon unique to New Zealand.

- Then we come to the chapter on Phil Verry's "interest-linked savings scheme". When Phil Verry first proposed this scheme to me when I was Governor, I took it seriously. As I have indicated already, the big cyclical swings in the exchange rate are indeed a pain in the neck for both exporters and those competing with imports. If a way could be found to moderate those swings, it seemed to me that there would be great benefits from doing so. I had several of my staff study the scheme for several weeks, and we involved an economist from Lincoln University who was claimed by Mr Verry to be supportive (Paul Dalziel, brother of Leanne Dalziel). Unfortunately, I did not keep a copy of the report we eventually sent to the Minister of Finance (who I am almost certain was Bill Birch at that time), but though I can't now recall all the details, I clearly recall that we concluded that his scheme would not be workable. Certainly, it would not work in the way described by Gould, who again clearly envisages that the Reserve Bank could somehow be totally divorced from the interest rates in the New Zealand economy.
- And then in the chapter entitled "International measures", Gould clearly envisages returning to the days of exchange controls. Yes, many developing countries still have them, but no developed country has to date seen fit to reintroduce them. He talks of the "need to protect ourselves against the ruthless exploitation of our goodwill by economic forces that are prepared to use their huge power to override our national interests". This may play well down at the CTU, but is far removed from reality. As I have already noted, no company which has tried to get resource consent to build a new pulp mill, or to introduce a new plant variety, or to dam a river to generate power believes that "economic forces" can use their "huge power" to "ruthlessly exploit" and override our national interests.

John, this letter is vastly longer than I had intended it to be, but long as it is, there are still a number of points which I have not addressed. As I said at the beginning, there are three or four points Gould makes with which I am in agreement, but the basic thrust of his argument I disagree with quite fundamentally. Hope my comments are helpful.

Best regards,

Don Brash