

Why does New Zealand have high interest rates?

Does it matter and, if so,
what can be done about it?

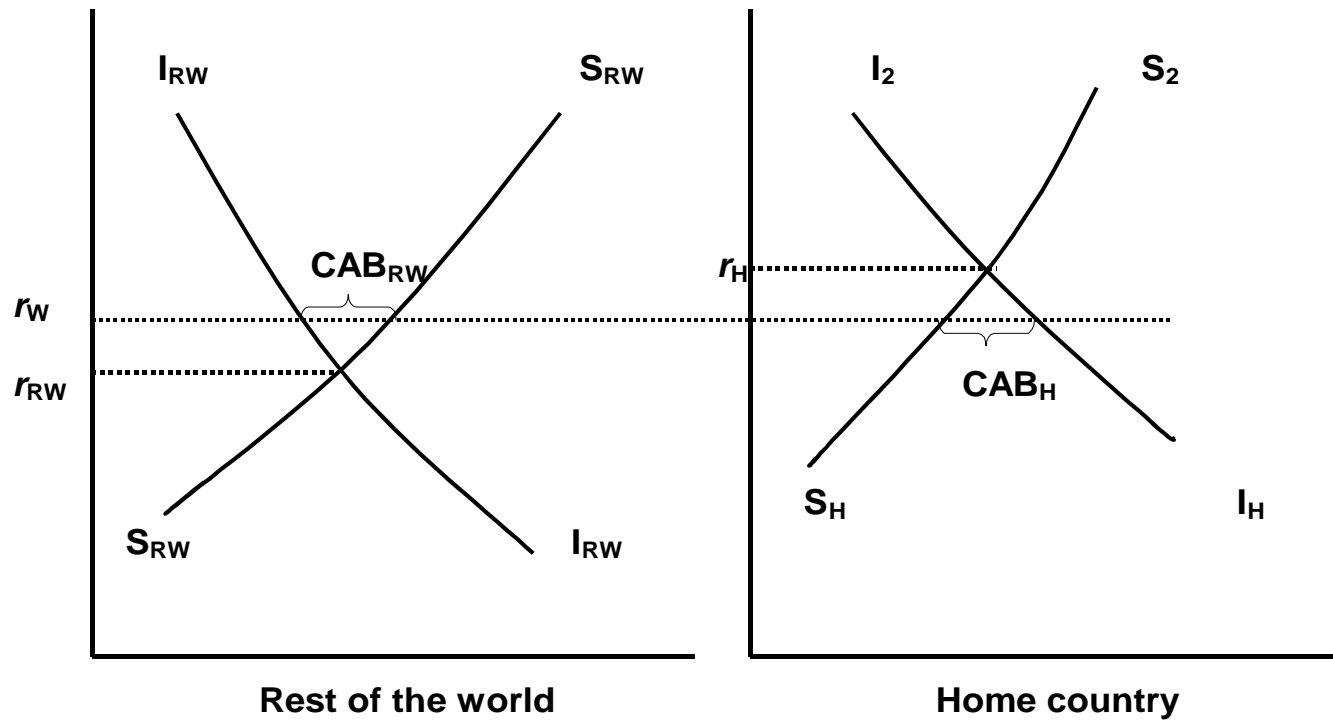
A seminar presentation by Dennis Rose
Institute of Policy Studies
Wellington 9 March 2012

Where do interest rates come from?

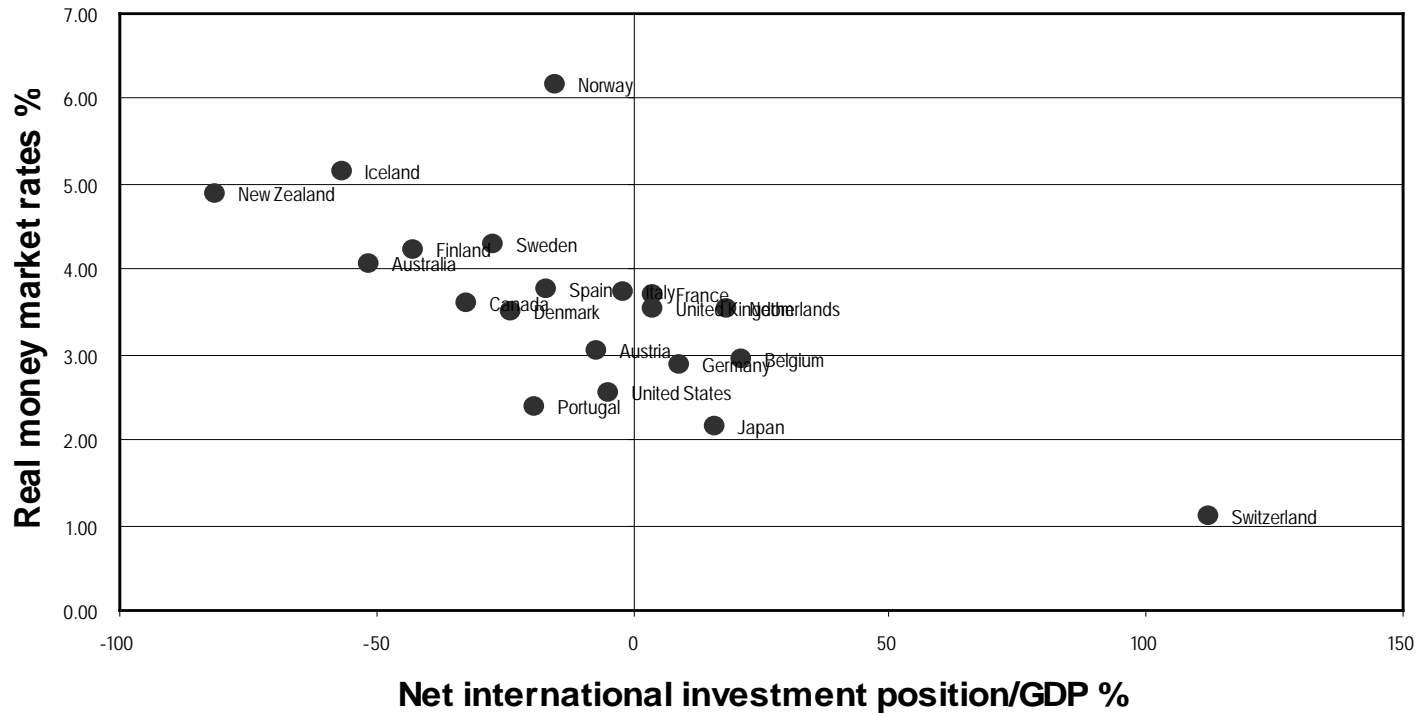
- Savings and investment
- Monetary conditions
- Risk

- Both national and international influences in play

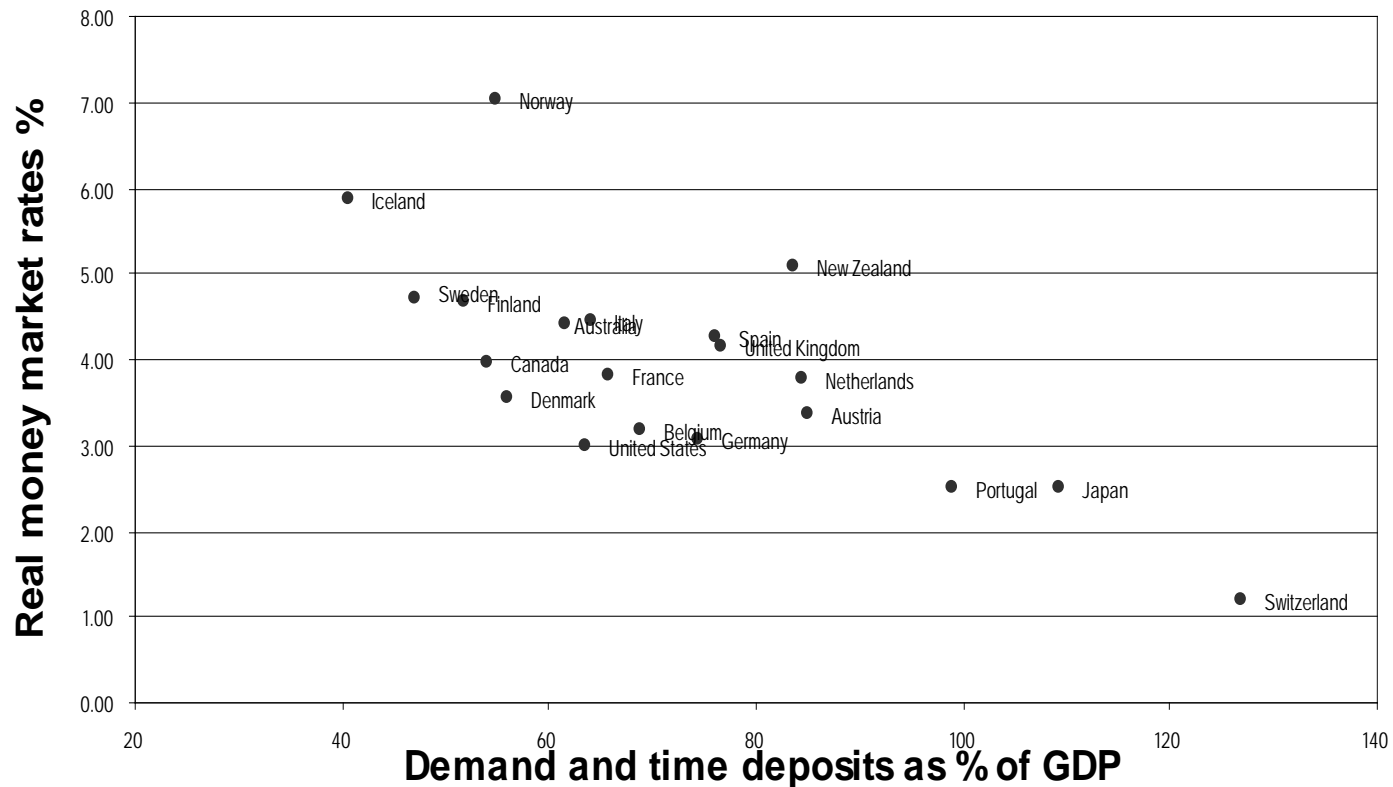
The world interest rate in a two country world



Real interest rates - NIIP



Real interest rates - Deposits



Two country matrix

		Sectoral liabilities recorded in columns		
		Home economy	Rest of world	World
Sectoral assets recorded in rows	Home economy	HA_H HL_H A_{11}	$HA_R = RL_H$ A_{12}	
	Rest of world	$RA_H = HL_R$ A_{21}	RA_R RL_R A_{22}	
World				

Sectoral matrix assets and liabilities

		Sectoral liabilities recorded in columns			
		Domestic real economy	Domestic banking sector	Rest of world	World
Sectoral assets recorded in rows	Domestic real economy (business, households, government)	$DA_D = DL_D$ Real assets, net worth B_{11}	$DA_B = BL_D$ Cash, demand and time deposits B_{12}	$DA_R = RL_D$ Deposits, loans, equity B_{13}	
	Domestic banking sector	$BA_D = DL_B$ Advances B_{21}	$BA_B = BL_B$ Interbank assets = liabilities B_{22}	$BA_R = RL_B$ Overseas assets and reserves B_{23}	
	Rest of World	$RA_D = DL_R$ Deposits, loans, equity B_{31}	$RA_B = BL_R$ Capital, loans and deposits B_{32}	$RA_R = RL_R$ Real assets, net worth B_{33}	
	World				

Risk - Coefficients on asset variables

(Intercept 4.0, Country size – 0.03, Rsq 0.5)

Net international investment position	-0.0206 *** 0.0023	-0.0157 *** 0.0031		
International assets			-0.0158 *** 0.0037	
International liabilities			0.0162 *** 0.0051	
Demand and time deposits		-0.0124 ** 0.0055		
Demand deposits			-0.0150 0.0166	
Time deposits			-0.0121 ** 0.0057	
Net financial assets				-0.0201 *** 0.0025

Short run equation (*Delta i*)

- Small positive coefficient on next year change in real exchange rate
- Lagged country cycle, 0.38 approx
- Lagged residuals from long-run equation -0.4 approx

Implied interest rate differentials

	Net financial assets (as percent of GDP)	Implied interest rate differential
New Zealand	-99.6	2.00
United States	-21.5	0.43
Japan	-6.3	0.13
Switzerland	70.4	-1.42

Alternative long-run specifications

(Dependent variable National real interest rates)

	(1)	(2)	(3)
Underlying world rate	Period effects	Productivity	Productivity
		World demand and time deposits	World demand and time deposits
National risk factors	Net asset variables	Net asset variables	Country effects
	Country size	Country size	

More detail on Specification 2

- Intercept
- World labour productivity } ($\delta + \eta g$)
- World demand and time deposits
- National net asset variables
- Country size
- National labour productivity

The underlying world rate

Intercept	2.03 *** 0.62	2.19 *** 0.63	3.18 *** 0.61	2.20 *** 0.64
World productivity	1.04 ***0.31	0.94 *** 0.31	0.48 0.30	1.01 *** 0.31
World demand and time deposits	-0.21 *** 0.02	-0.19 *** 0.02		-0.22 *** 0.02
World demand deposits			-0.42 ***0.05	
World time deposits			0.10 ** 0.05	

Risk - Coefficients on asset variables

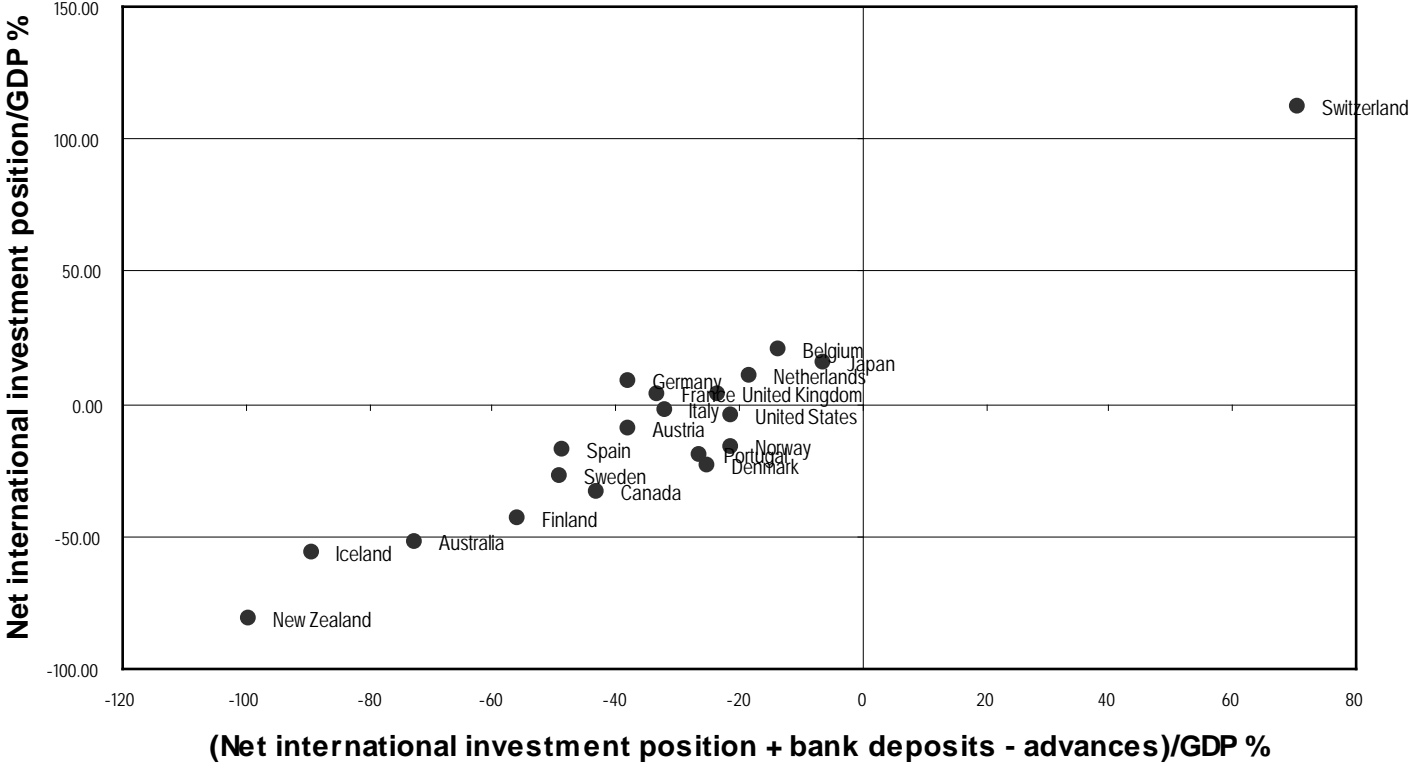
(Country size – 0.04, Rsq 0.33)

Net international investment position	-0.0205 *** 0.0028	-0.0142 *** 0.0036		
International assets			-0.0124 *** 0.0039	
International liabilities			0.0101 * 0.0054	
Demand and time deposits		-0.0164 ** 0.0066		
Demand deposits			-0.0265 ** 0.0127	
Time deposits			-0.0118 ** 0.0065	
Net financial assets				-0.0197 *** 0.0030

Short-run equation

- Delta world demand and time deposits -0.33
- Lagged world and country cycles, each 0.5
- Lagged residuals from long-run equation -0.5
- Reverse causation from real interest rates to world demand and time deposits

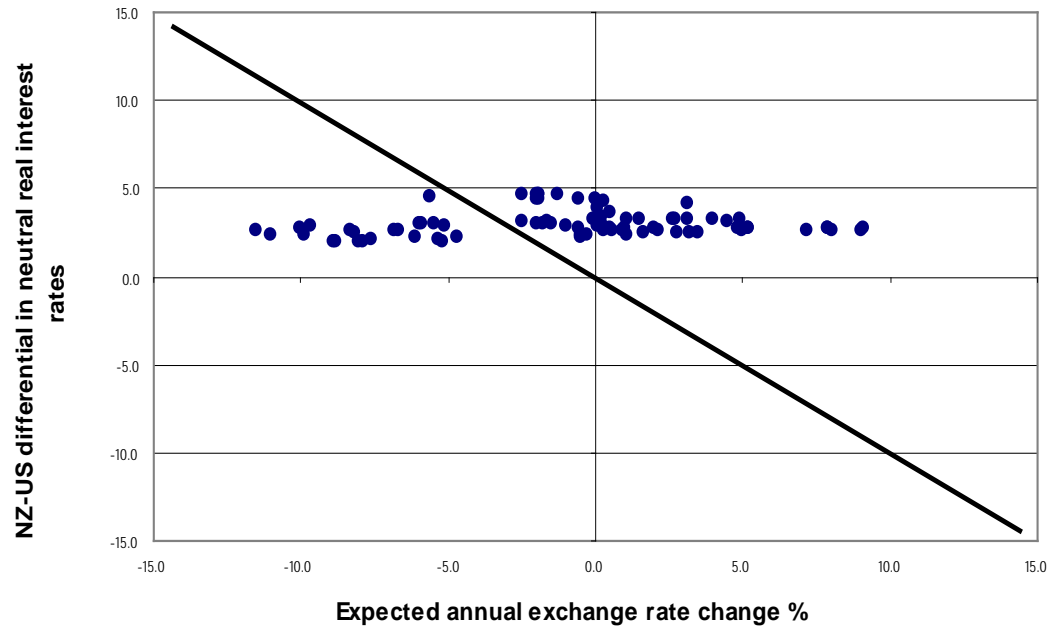
Net international investment position and net financial assets



Compatible stories?

- $\Sigma \text{CAB} \rightarrow \text{NIIP}$
- $\Sigma(S - I) \rightarrow \text{Net financial assets}$
- National accounting identity $\text{CAB} = S - I$
- Labuschagne and Vowles (Carry trade)
- Burnside (High NZ interest rates
compensation for for the risk of rare and
extreme events)

NZ-US interest rates and exchange rates (1990-2009)



Caveats

- Inherent uncertainty of asset values
- Differing views on asset values underly the dynamics of capital markets
- Nevertheless these regularities deserve further work

Implications

- High net liabilities constitute ongoing risk
- High interest rates discourage investment and so inhibit growth in incomes
- High interest rates tend to elevate exchange rate and thereby prejudice CAB
- Point to the need for better $(S - I)$ and CAB

Structural response

- For a small economy a high degree of internationalization is a pre-condition of high per capita income
- Imports a prerequisite for both production and high consumption standards
- This presupposes strong export performance
- It was ever thus – but now arguably more so

Economic Management 14 July 1984

“As government overseas borrowing is reduced, individuals may themselves choose to borrow overseas either directly for investment (if the rate of return on domestic investment exceeds the cost of overseas borrowing) or for current consumption (in which case they are, implicitly, trading current for future consumption). Any resulting external current account deficit would not be a cause for concern, and would merely be reflecting individuals’ choices between current and future consumption.” (The Treasury, page 162)