Activity over substance:
New Zealand monetary policy 2020

Presentation at Victoria University of Wellington

12 December 2020

Michael Reddell

Outline of presentation

- What is monetary policy supposed to be doing?
- New Zealand monetary policy 2020
  - Minimising the issues until mid Feb
  - Favouring a negative OCR but failing to prepare
  - LSAP programme
  - Funding for lending
  - Housing (not a mon policy responsibility) and politics
  - Nine months on where do we stand?
  - How should we evaluate the Bank's/MPC's performance?

What is monetary policy about?

- Active monetary policy is a pretty new thing
- It is primarily about stabilising the economy - esp leaning against severe downturns,
- Price stability - low and stable inflation - isn’t the goal (can get that with, say, a Gold Standard) but a constraint on discretion,
- Point was somewhat lost sight of in 1989 Act,
- Amendment act in 2018, and MPC remit, came closer to capturing this perspective

The goal set for the RB Monetary Policy Ctte

1) Monetary Policy Objectives

a) Under Section 8 of the Act the Reserve Bank, acting through the MPC, is required to formulate monetary policy with the goals of maintaining a stable general level of prices over the medium term and supporting maximum sustainable employment.

2) Operational Objectives

a) For the purpose of this remit the MPC's operational objectives shall be to:

i. keep future annual inflation between 1 and 3 percent over the medium term, with a focus on keeping future inflation near the 2 percent mid-point. This target will be defined in terms of the All Groups Consumers Price Index, as published by Statistics New Zealand; and

ii. support maximum sustainable employment. The MPC should consider a broad range of labour market indicators to form a view of where employment is relative to its maximum sustainable level, taking into account that the level of maximum sustainable employment is largely determined by non-monetary factors that affect the structure and dynamics of the labour market and is not directly measurable.

What that entails

- In most downturns, it means big cuts in the policy interest rate
  - 1991 recession short-term rates down 600bps
  - 1997/98 almost 400bps
  - 2008/09 575 bps
- Which, in turn and in NZ, typically leads to big falls in the exchange rate
- Cuts of this magnitude are quite normal elsewhere: often 500bps cuts in the US
- Aim is to stabilise demand, support expectations of future inflation, and hold up actual inflation

2020: Initially minimising the issue

- Feb MPS - presented as a little local difficulty, mostly in China, which would soon be got over,
- Adopted a mild tightening bias
- Two weeks later still tweeting about the expected upturn this year ("more investment, more jobs")
- And into March they were still openly suggesting there weren't monetary policy issues

Beginning to act: 16 March

- OCR cut by 75bps, a fairly big move

- Announced a commitment not to change OCR for 12 months come what may (in the midst of rapidly escalating uncertainty)

- And indicated that if anything more was needed, they’d do large scale asset purchases
  - An instrument their chief economist had played down just days earlier

Negative OCR: just not ready

- For some time the Bank had openly talked about negative OCR potential
- Various other advanced countries had used the tool for ages
- Their own working group highlighted in 2012 the need to ensure banking system ready,
- But it appears they only discovered in Jan that perhaps banks weren’t ready at all (and still no hint of this until 16 March)
- Extraordinary failure by an institution that saw neg OCR as a desirable option in the toolkit

LSAP

- Announced/launched just a few days later
  - Initially about crisis conditions in global govt bond markets,
- Size of programme and range of instruments covered has grown
  - But overwhelmingly NZGBs, buying on a really large scale
- Quite explicit that the instrument was primarily about influencing interest rates and the exchange rate
- Secondary market purchases – altho RB openly toyed with direct financing to govt (govt wasn’t interested)

Understanding the LSAP

- For all the talk about "money printing" - images of Weimar 1923 – it is nothing of the sort,
- It is really little more than a big asset swap of two fairly similar assets
  - Bank buys relatively long-dated government bonds,
  - And issues in exchange short-dated government liabilities (RB settlement balances)
- One wouldn't expect a big macro impact of such a swap - absent, perhaps, a severe crisis in the market of one of those assets.
- And in my read of the evidence we haven't seen a big macro impact

Understanding the LSAP

- Issuing lots of new settlement cash balances might have a big impact if
  - Those balances were earning a well below market return (but since March RB has been paying full OCR rate)
  - Some individual banks were really struggling with liquidity availability (but they aren’t) and that was what was holding back lending
- And it also depends on the counterfactual:
  - On the RB’s own telling, they would have used LSAP less if negative OCR had been an option

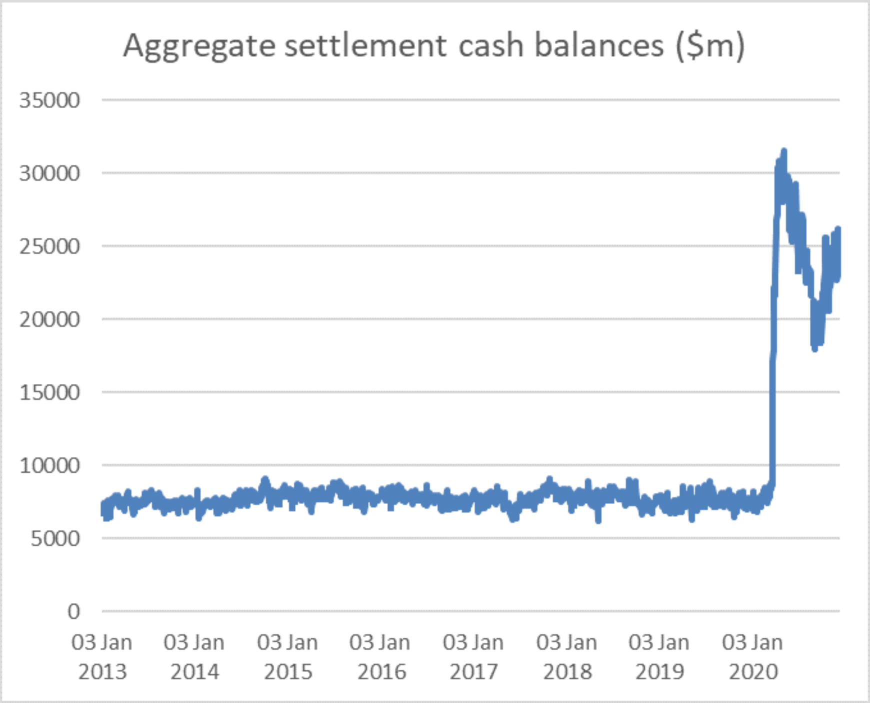
What did provide support then?

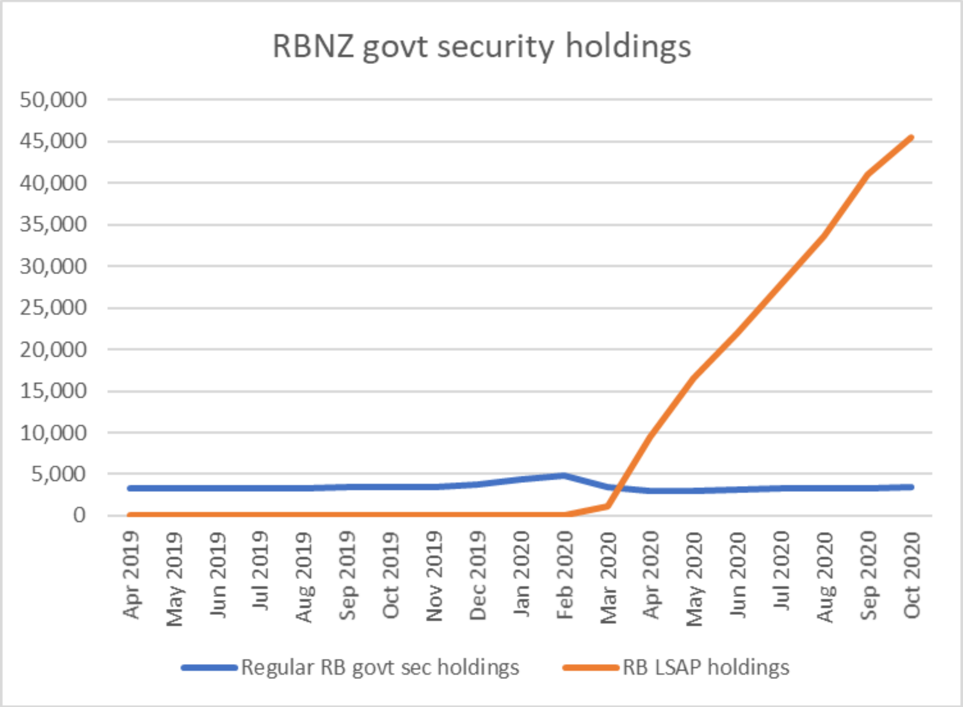
- Fiscal policy (eg wage subsidy)
  - It was the deficit that put more money in bank accounts of firms and households (“money supply”)
  - And monetary policy made no difference to how large a discretionary deficit the govt chose to run
- Mortgage holiday provisions
- Temporary easing in LVR limits

Probable LSAP effects

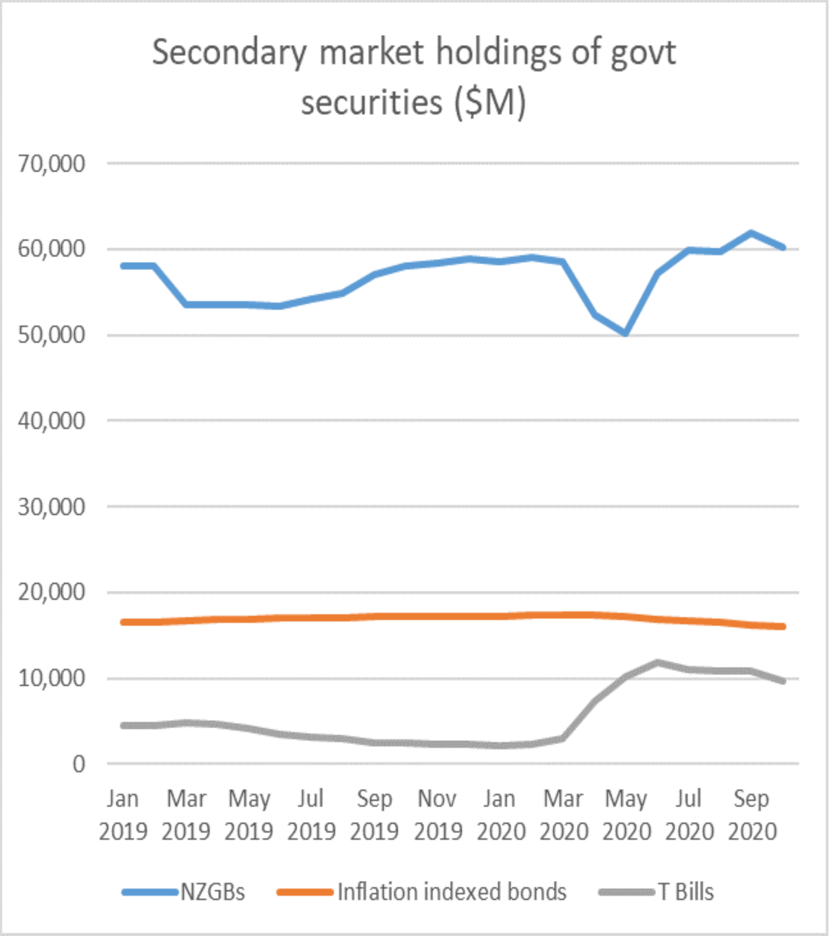
- Nothing much on govt bond (or swap) rates out to, say, 2-3 years, since those risk-free rates are anchored by future OCR expectations
- Some impact - perhaps a few tens of bps – at longer end of govt bond market (but nobody much - govt apart - raises funds at long-term fixed rates, so not much macro benefit),
- Perhaps the exchange rate a bit lower than otherwise, but again…counterfactuals matter
- Perhaps supported inflation expectations a little, but…counterfactuals
- Made not a jot a difference to bank lending (nor did RB claim otherwise)

Some data (with avoidable lags)





Some more data



- So private sector bond holdings are much as they were a year ago (no wholesale money sloshing around)
- So, as it happens, are foreign holdings
- T bill issuance has increased, but just another short-dated govt liability (not much diff to sett cash)

Alternative media narrative

- Tens of billions sloshing around keenly seeking a home, driving up lending and other asset prices
- Mostly a nonsense story
- To extent deposits are up, about fiscal policy
- Lending itself isn’t up much at all (household up, business down)
- As RB itself has stressed, weak business lending is mostly about uncertainty (for lenders and borrowers)

Funding for lending

- Latest RB clever wheeze, went into operation this week
- On their own description, it is just about getting market interest rates down a bit relative to OCR
- Has done a bit of that - useful, but not transformative
- But RB framing (incl scheme name) left impression:
    - Banks were strapped for cash, holding back lending
    - $28bn will be out there pursuing new lending
    - Banks (in aggregate) don’t need more sett cash to lend, and not much of FFL is likely to be drawn (RB agrees)

Housing

- Most (incl me) expected house prices to fall a bit this year
- Typically happens in recessions, as do large falls in interest rates
- This year we had
  - Quite small falls in interest rates
  - Lifting the lid off financial repression
  - Mortgage holidays delaying forced sales
  - More generous than usual income relief

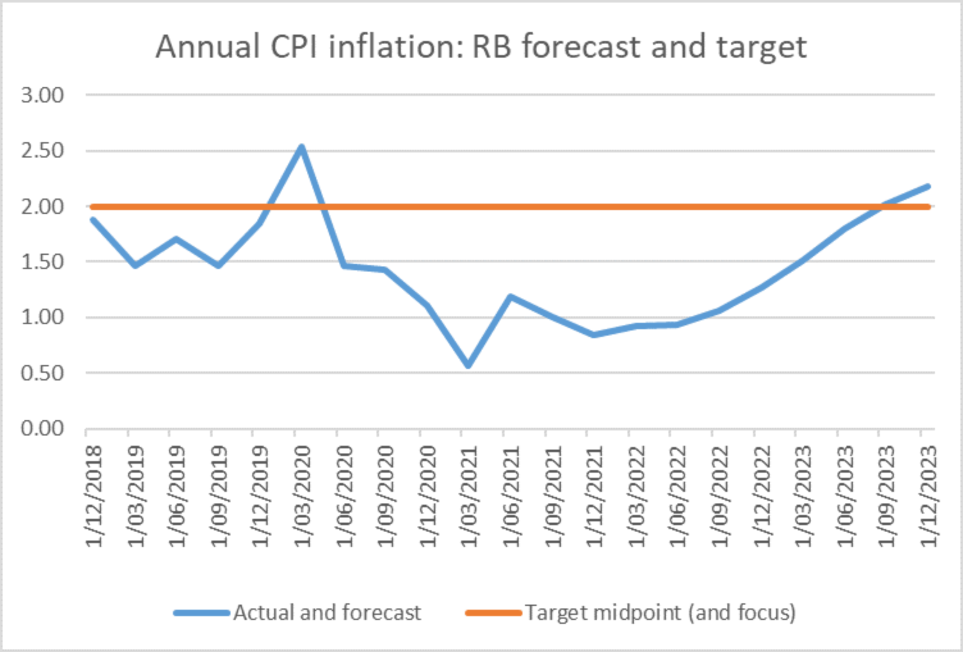
Housing

- Not really plausible that mon policy is the main story (see above)
- LVRs will have mattered
- Bigger issue is that land use restrictions (and whatever other structural problems you prefer) - one RB has identified in public
- But RB their own enemy, talking of the alleged benefits to the economy from higher house prices
- And thus invited the political theatre of the Minister's letter
- More focus of mon pol on house prices would mean (a) even lower gen inflation (higher real int rates) and (b) higher unemployment

Overall macro position

- We’ve had more of a rebound than many had expected (Covid restrictions lifted faster than RB/Tsy assumed
- Good news, but lots of uncertainty, v difficult world economy, and
  - Still rising unemployment
  - Inflation (core) below target for a decade, expected to fall further
- I’m not going to interpose my macro forecasts here but rely on the RB’s (Nov MPS)
- They have stressed risks to these projections are to the downside

Both parts of the mandate suggest looser policy needed (govt set mandate)



- What about the unemployment rate, still probably the best indicator of excess capacity? They expect that the unemployment rate will keep rising and will be still 6.3 per cent by the end of next year. And at the end of 2023 – more than 3 years away – they still think the unemployment rate will be 5.2 per cent, barely lower than the current 5.3 per cent.

Least regrets

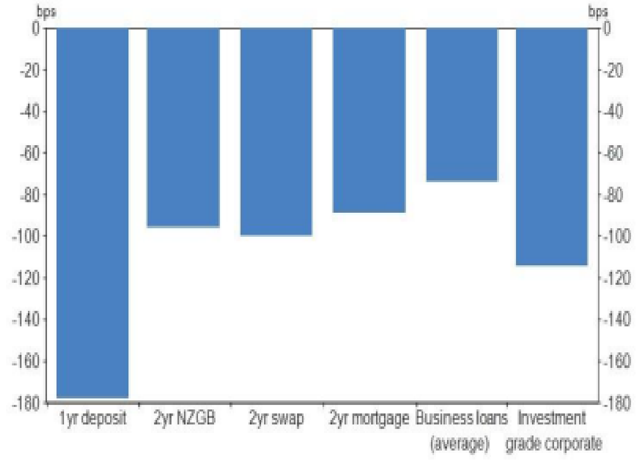
- Bank talks a good talk about a “least regrets” approach
  - Have done since second half of 2019
  - Say they would prefer to do too much, and have inflation overshoot, than too little
- It is exactly the approach they should be running,
- But, ON THEIR OWN PROJECTIONS, it bears no relationship to how policy is actually run
- Lots of handwaving and rhetoric, but it looks as if they are scared of inflation going above 2%
- Otherwise, eg, the OCR would be cut now.

Handwaving and rhetoric

- Bank likes to talk about "how much" it has done
- And the big stimulus it is bringing to bear
- (Even as it sometimes claims to be a secondary player)
- Chart from Gov's speech looks superficially impressive

Figure 8: Change in New Zealand interest rates

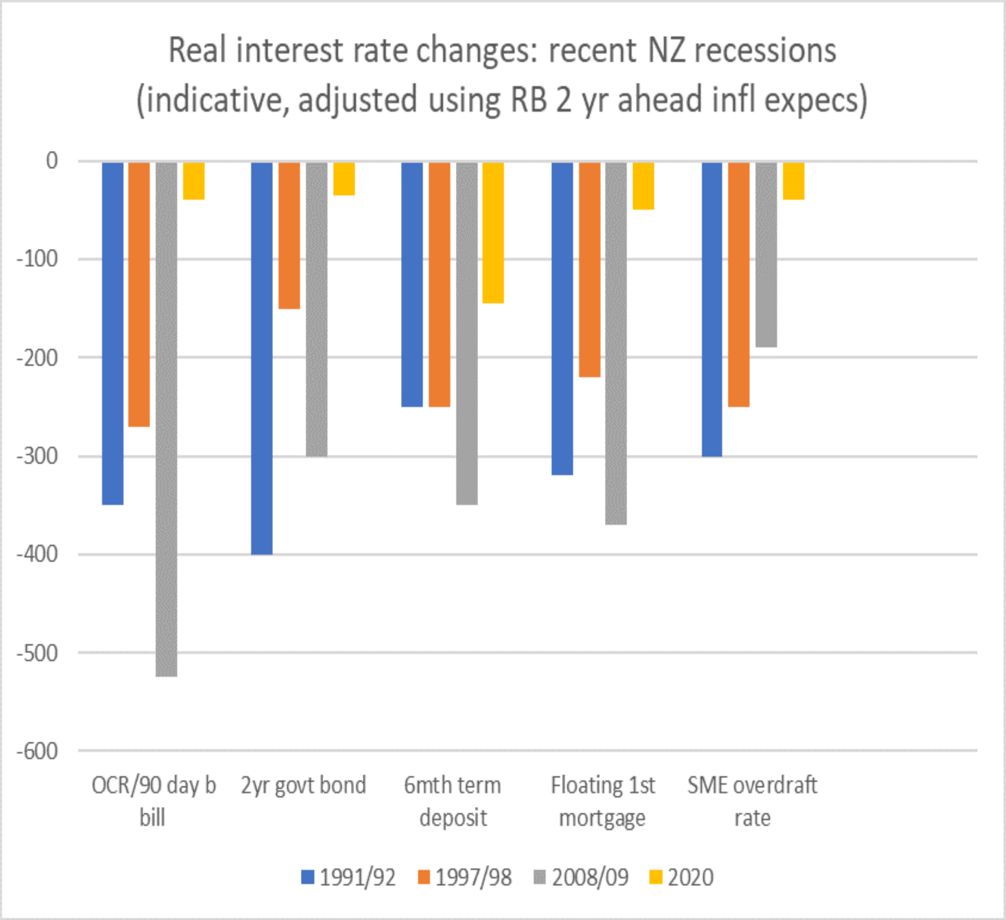
(change since beginning of 2020)

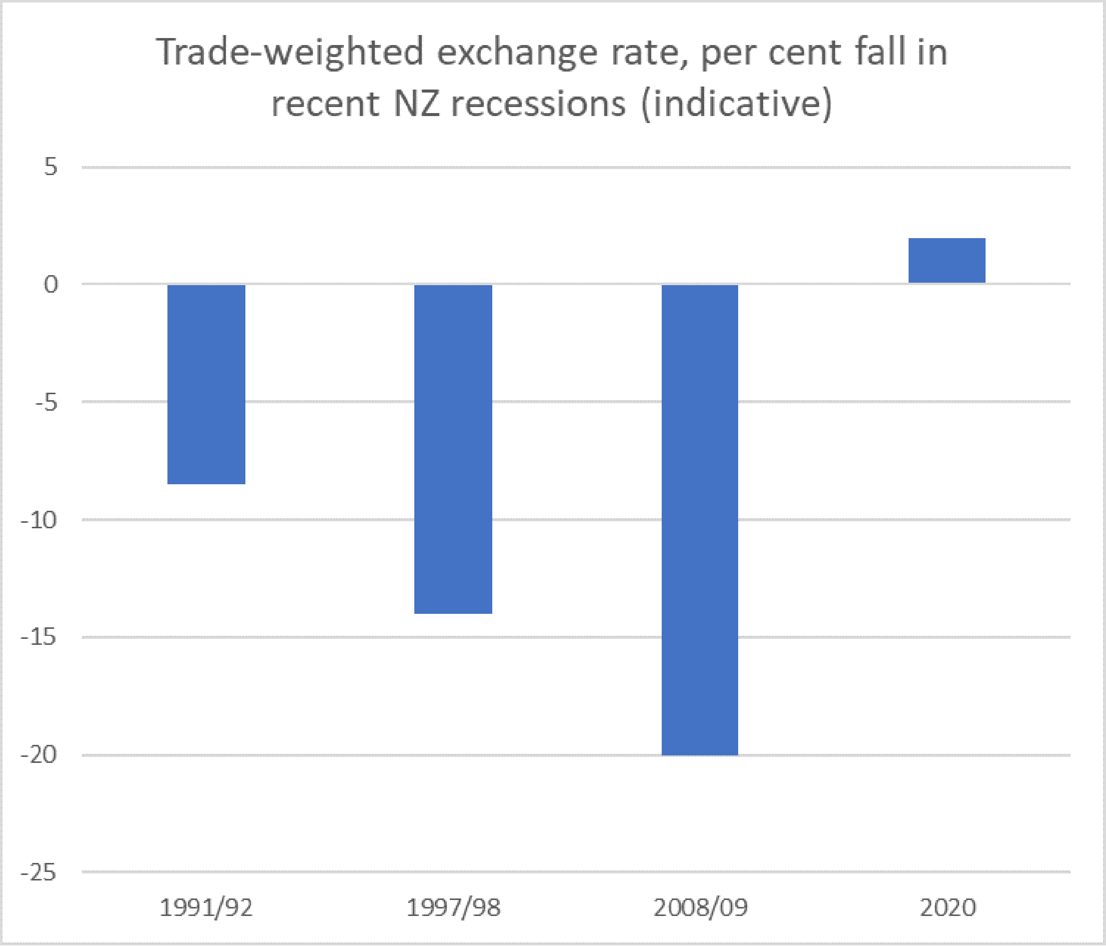


Source: Bloomberg, interest.co.nz, RBNZ

Note: Data for business loans reflects the change in the average interest rate on outstanding business loans. Other rates are based on advertised and market rates

With all their programmes, cumulative effect is small by past recession standards





How to evaluate RB performance

- Failed to recognise and respond to emerging risks
- Failed to be ready for negative OCR, despite signalling it wanted to use it
- Failed to operate laudable “least regrets” approach, on their own numbers
- Poor communications, and framing of issues, feeding narratives about reckless money printing, for interventions with only modest effects
- Not at all transparent - whether documents, speeches, or the invisible non-exec MPC members

Evaluating the Bank

- Better mon pol this year would not have made a huge difference to macro outcomes yet
- But would have set foundations for a much stronger rebound next year, incl a quick return to full employment
- Better communications, transparency, framing etc would have stood the Bank in better stead, which has to be a good thing if we value operational independence.
- Reflects poorly on Governor, senior management, MPC, Board and MoF.

Q&A

- This is an idiosyncratic minority view on the RB, but I think it is pretty robust

- Happy to elaborate and to attempt to answer questions