

# Appearing to be active, but accomplishing little

New Zealand monetary policy in 2020

Notes for a lecture at VUW, 12 December 2020

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## What is monetary policy for?

Central banks doing the sort of stuff central banks now do are a fairly modern creation. Can date nascent central banks back several hundred years, and even some of today's central banks (BOE, Riksbank) have origins in the 17<sup>th</sup> C.

But central banking - the monetary policy side - as we know it today really stems from the Great Depression, a bit less than 100 years ago. In fact, in New Zealand the Depression was the prompt that finally led to the establishment of our own Reserve Bank of New Zealand. Having our own state-issued currency not convertible into (say) gold enabled us – and other countries - to use monetary policy to lean against significant downturns in economic activity.

Modern central banking was never primarily about a stable general level of prices. You don't need state-issued fiat money - money we just take on trust - to get a stable general level of prices over time. Commodity standards, like the Gold Standard, will give you that. UK prices in 1820 were much the same as those on the eve of WW1. But defending a fixed link to gold meant little flexibility to respond to significant adverse economic shocks. Creating - and using – that freedom is what modern discretionary monetary policy is about. Of course, inflation matters a lot, but it is a constraint on what central banks can do to support the economy, not the primary point.

The new way the Reserve Bank's mon pol objective was described in the 2018 amended legislation came closer to capturing this, entirely common, way of seeing things.

In a very reduced - perhaps excessively crude - summary, if trend inflation is well above target, too much monetary support has been thrown at the economy in the past, and if below target, too little support has been given. The inflation target is supposed to prompt the Reserve Bank to lean, appropriately hard, in the right direction. For a long time, the worry was about the genie getting out of the bottle again - some reversion to the bad old inflationary days of the 70s and 80s. But for the last decade inflation has, on average been undershooting the target, and central banks (here and abroad) have been underestimating what they needed to do (or could do - getting unemployment further down without inflation racing away).

Most - but not all - economic downturns raise unemployment, and result in a fall in (core) inflation. In principle, monetary policy decisions then should be easy, since both the falling inflation and rising unemployment elements all point in the same direction. The market-clearing interest rate is falling and the Reserve Bank needs to keep pace by cutting the policy rate (the OCR). Typically, the RB cutting the OCR by quite a bit also results in the exchange rate falling. That also helps generate more domestic economic activity and, over time, get inflation back nearer to target. Since forecasting is hard - perhaps almost impossible - no one expects central banks to get things right all the time. Errors are inevitable, but systematic biases are a problem.

Monetary policy is typically used quite aggressively in economic downturns. This is our 4<sup>th</sup> fairly serious downturn since the Reserve Bank was made responsible for monetary policy.

- In the 1991 recession, short-term interest rates fell by about 600 basis points, with the blessing of the RB,
- In the less severe 1998 downturn, short-term interests fell by about 400 bps, again with the RB blessing,
- Shortly thereafter the Bank started setting the OCR directly. In the 2008/09 recession, the OCR was cut by 575 basis points.

In each case, the exchange rate also fell quite a long way. In combination, lower interest rates and a lower exchange rate helped support an eventual recover and limited the extent of the fall in inflation.

That is what central banks in small open economies do in downturns. Big country central banks do much the same – in typical recession the Fed cuts by about 500 bps - but some of them are ‘safe havens’, so don’t always get the same help from the exch rate.

## **2020 Monetary Policy**

Not all OCR changes are in response to big changes in the economy. In the second half of last year, our Reserve Bank - like quite a few overseas peers – had cut the OCR. The economic outlook appeared to be weakening a bit, and inflation was still a bit below target. But by the end of the year, sentiment had begun to turn, at least in NZ, and many market commentators were back to one of their favourite games - picking when the OCR might be raised (even more than the RB, markets had spent the decade focused on when rates might return to “normal”).

At that point, of course, no one paying any attention to NZ (or similar country) markets and monetary policy had heard of Covid-19.

But that changed quite quickly. By late January, the People’s Republic of China (PRC) had locked-down the entire city of Wuhan. Then they banned people leaving China on package tours etc, and within days New Zealand (following Aus and the US) had banned arrivals from China. If you look thru the papers the govt has since released, we know that by late Jan some of our exporters - notably crayfish – were having problems, and since the academic year was just about to get underway, the inability of PRC students to get here was also going to be a problem.

The Reserve Bank had its first MPS and OCR review on 12 Feb. We don’t expect central banks to be experts in infectious diseases and pandemics, but it is still astonishing looking back quite how complacent the Bank then was about Covid - esp as the Secretary to the Treasury is a non-voting MPC member, and they had ready access to MoH perspectives. The case for a precautionary OCR cut was pretty strong - this isn’t just hindsight, as I made that public call at the time - but instead, remarkably, the Bank treated Covid as a fairly minor and temporary problem, mostly about China, and actually published an interest rate track that suggested a tightening bias - if anything, they thought their next move, albeit some time away, was more likely to be a tightening than a loosening.

They stuck with that stance even as the global situation rapidly worsened. On 25 Feb - Italian lockdowns had started by then - almost two weeks later, there was a tweet authorised by senior management in which they stated

*“One of our jobs at the Bank is to forecast where we think the economy is heading. While there is still things that could trip up our prediction, we expect activity will pick up later this year, meaning more investment, more jobs & higher wages.”*

And so it went on. Senior management were still giving speeches and interviews in the second week of March suggesting that if there were any issues they weren't really about monetary policy, but about access to funding/liquidity.

Until, finally, something snapped and an emergency meeting of the MPC was called, and early on the morning of 16 March, they announced a 75 bps cut in the OCR (to 0.25 per cent).

That was good, as far as it went. Quite a large move in one go (although less than Fed moved later that day).

The problem was in the second half of the announcement.

*The Committee agreed unanimously to keep the OCR at this level for at least 12 months.*

*The Committee also agreed that should further stimulus be required, a Large Scale Asset Purchase programme of New Zealand government bonds would be preferable to further OCR reductions.*

### **Handling lower bound issues**

Now one of the problems that people had long been aware of was that the lower bound on nominal interest rates - when people would switch to zero-earning physical cash instead, rendering monetary policy largely ineffective - was approaching. In various other countries, those limits had been reached in the previous severe downturns: in some countries just above zero, and in some others (Japan, Sweden, the euro-area most notably) a bit below zero.

It was an issue the Reserve Bank itself had been well aware of. As far back in 2012 - in the midst of the euro crisis - I'd chaired an internal working group on issues and options around handling a renewed severe downturn. We'd concluded that the OCR could probably be cut to perhaps -75 bps but had recommended to the Governor that the Bank should ensure that its own operating systems and those of the banks were adequately able to cope with such modestly negative interest rates. Those recommendations were adopted.

A few years on, the Bank had got round to doing some further work on thinking about options for the next downturn. There was an interesting Bulletin article in 2018, and in August 2019 the Governor had given a long and substantive interview (to Newsroom) suggesting that a negative OCR was the best way to go<sup>1</sup>, and indicating that a proactive even pre-emptive was desirable, because the Bank wouldn't want to see inflation expectations falling away (if they did, it made it all the harder to keep actual inflation near the target). In his speech in early March 2020, the Governor had given no hint of any doubts about the negative OCR option (even appearing to suggest the Bank

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<sup>1</sup> There is, of course, some debate (here and abroad) about the potential usefulness of negative policy rates. I don't have time to deal with those issues here, but my own stance is that a negative OCR would be an effective and useful part of the transmission mechanism, including through an exchange rate channel. Over the last couple of years the RB appears to have held a similar view.

would consider more far-reaching changes - re convertibility to cash - that gave rise to the lower bound issue in the first place. To top it off, just a few days before this unscheduled intervention, the Bank's chief economist was quoted in the *Herald* suggesting that asset purchases didn't really have that much to offer in terms of monetary stimulus.

And yet...what the MPC now offered us was a statement that, come what may, the OCR wouldn't be changed for 12 months, up or down, and that instead asset purchases would have to do what was needed.

Context matters and it is easy to lose track of timings in the eventful 2020. At this point, no one in the Reserve Bank - and in fairness no one much elsewhere in govt - seemed to have any idea that within 10 days the New Zealand economy would be in the midst of an extreme lockdown, no sense of the wave of economic disruption here and abroad about to break over them. They seemed to have little idea of tourist bookings from around the world already drying up, or of the sort of self-protecting reductions in movement in economic activity that were about to take on much greater prominence here. But even they should have recognised just how uncertain the economic environment was, and how high the risk of further falls in inflation expectations was.

And yet - the Committee unanimously - made this absurd pledge not to alter the OCR at all for a year.

We still don't really have a good sense as to why they made such a rash pledge - and no other central bank ever, that I'm aware of, has promised not to cut interest rates no matter the bad the downturn gets. The so-called minutes are rarely revealing, and the Bank has refused all requests for relevant papers or analysis lodged under the OIA. Another failing, they aren't very transparent, even in a period of extreme uncertainty.

But what did quickly become clear, and was confirmed from some OIAed material, was that even though the Bank had known for years of the possible need for negative rates, even though the Governor had talked up the option only last year, nothing - repeat nothing - had been done to ensure that banks were readily able to operate with a negative OCR. This is such an extraordinary failing by Bank senior management - and its Board paid to hold the Bank to account, and the Minister of Finance for that matter - that it is astonishing it hasn't had more attention. Some central banks abroad are sceptical of the usefulness of a negative OCR: ours isn't and yet did nothing to ensure it was ready when the severe downturn engulfed us. (It has always been something of a mystery quite how much, and how many, banks were unprepared - since wholesale rates in various major markets had been negative for years, NZ indexed bonds had at times traded negative from last year, and a slightly negative OCR didn't imply generally negative retail rates. But....what was, was, and the Bank now very belatedly assures us that the banks have graciously got themselves ready in case the Bank judges a negative OCR to be warranted.....when that commitment to do nothing for a year finally runs out in March.)

By the way, none of that "banks not ready for negative rates" stuff explains or justified - then or now - the MPC's refusal to cut the OCR to zero. To simply not use all conventional monetary policy capacity in the circumstances of this year is almost inexcusable.

[For completeness here - although I don't have time to develop the points - I should not here (a) the Bank's sensible actions in mid-late March to intervene in the troubled fx swaps market, where problems were soon resolved, and (b) using prudential powers, to suspend - they said for a year - LVR limits, and to make the core funding requirement non-binding. All these were sensible and

prudent steps, in the LVR case especially as the govt and the Bank were encouraging banks to provide temporary mortgage payment holidays, to provide cash flow relief.]

### **Large-scale asset purchases**

But to revert to mid to late March, a few days after that 16 March announcement - itself followed the next day by the government's own first fiscal package (it too oblivious to the scale of what was about to break over them) - the new asset purchase programme was rolled out, under the label Large-scale Asset Purchase programme or LSAP. The amounts the Bank was offering to purchase have been increased a couple of times and the range of securities they will purchase has been widened (now including LGFA bonds, as well as - mostly - government conventional and indexed bonds).

At the time of the announcement there were quasi-crisis conditions in government bond markets globally, but centred on US treasuries. These extreme liquidity pressures and rush to cash among wholesale investors prompted a significant rise in government bond yields here and abroad - not at all the helpful direction as a severe economic downturn was beginning to unfold. Those pressures passed relatively quickly. They would have passed - abroad and, indirectly, here - even if our Reserve Bank had done nothing. One can mount an argument that intervention to ease those liquidity pressures simply feeds moral hazard and was both unnecessary and inappropriate, but in the circumstances I don't feel strongly on that point. I mention it mostly because the Reserve Bank likes to crow about how much beneficial impact the LSAP has had, but they often didn't allow for the fact that the immediate crisis pressures on spreads and yields would have passed fairly quickly - if a little more slowly than actually happened - anyway.

Note here - we'll come back to it<sup>2</sup> - that the Reserve Bank was purchasing the bonds on the secondary market, and the choice to purchase was that of the Reserve Bank alone.

There are two quite radically different views as to how the LSAP scheme is working, or is supposed to work. On the one hand, there is the mental model and rhetoric the Bank itself uses, and on the other hand there is a rather breathless line about "printing money" that gets a lot of coverage in parts of the media. On this one, I'm mostly with the Reserve Bank. They are right about the mechanism even if, probably, wrong about the magnitudes.

The Reserve Bank's view - repeated in numerous statements, interviews and published documents - is that the LSAP works largely by lowering wholesale interest rates and, in turn, by lowering the exchange rate. For any given volume of government bonds on issue - and the RB has no influence over how many the government issues - if the Reserve Bank is in the market in size it will, all else equal, raise the price and lower the yield on those bonds. This in turn, so they argue, lowers yields on interest rate swaps and also, so it is claimed, lowers the exchange rate. The Bank has produced no serious analysis at all to justify their estimates - including particular the passthrough to other rates - but they have claimed that government bond yields are 100-150 basis points lower than they would have been without the LSAP and that the exchange rate is perhaps 5 per cent lower than otherwise. They assert that this is pure economic stimulus.

It is hard to know the counterfactual, or even to know what the correct counterfactual is. There is no RB research to help us. But there are two possibilities:

- Rather than do the large-scale LSAP the RB simply did nothing more, or

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<sup>2</sup> Or not. Time/space prevent elaborating much on the monetary financing debate, initiated by the Governor.

- Rather than do the large-scale LSAP the RB cut the OCR more deeply

Either way a lot of longer-term government bonds would have been issued this year and, all else equal, that would have tended to raise long-term government bond yields relative to other interest rates, and especially relative to short-term wholesale rates that are more or less directly set by the RB.

All else equal, the LSAP has probably lowered those long-term government rates to some extent. They have probably had a larger effect on the bonds with the longest maturity dates BUT few private borrowers undertake fixed rate funding for those terms (no mortgage borrowers, few corporates), so the biggest beneficiary of low long-term government bond rates is not the wider economy (what monetary stimulus is about) but the government itself. That is nice for the government, but it isn't the statutory function of monetary policy.

At the short-end of the yield curve, the LSAP programme will have made no difference whatever, since the short-end is anchored by (a) today's OCR, and (b) expectations of the future OCR. If, for example, the OCR is expected to be held at or below current levels for three years, and to rise only gradually from there - which might seem like a reasonable take on expectations over recent months - today's five-year government bond rate won't be very much above today's OCR. Actual rates ebb and flow to some extent, with the outlook for (eg) vaccines and some prospect of a return to normal life. But the actual five year government bond rate is about 40bps, not very much above today's OCR. Perhaps there is some LSAP effect at work, but it simply can't be very large, bearing in mind that NZ govt net debt (% of GDP) remains low by international standards, so there is nothing that unusual about the amount of bonds on issue.

And if the interest rate effect is modest, it seems most likely that any exchange rate effect is small.

That was one counterfactual: instead of LSAP the RB does nothing. It seems plausible that they've generated a bit of macroeconomic stimulus, but it also seems most likely that the magnitudes are quite small - nothing like the amount the public seem to associate with \$100bn of planned bond purchases (or with the Governor's rhetoric).

The other possible counterfactual is that the MPC cut the OCR further instead. Maybe you buy the Bank's claims that commercial banks weren't operationally ready, but even if that was so there was nothing to have stopped the RB cutting the OCR to zero back in March/April and signalling that the OCR would most likely be taken negative just as soon as (operationally) possible. Since the Governor told an Australian audience last week that banks are operationally ready now, there is nothing that prevents the OCR being at, say, -50 bps now. Today. Had that been done all short-term rates (out to, say, a year) would be materially lower than the 20-30 bps they are now: that would have been real additional stimulus where it counted, including with probable tangible effects on the exchange rate. Just possibly, longer-term rates would have been a bit higher than they are now, but that wouldn't necessarily have been a bad thing, to the extent that such higher rates partly reflected a faster expected economic recovery and perhaps higher inflation expectations. And remember that if very long-term real government bond rates had been higher the only party it would have adversely affected would have been the government, but it would have made no difference at all to how large a deficit the government was running this year.

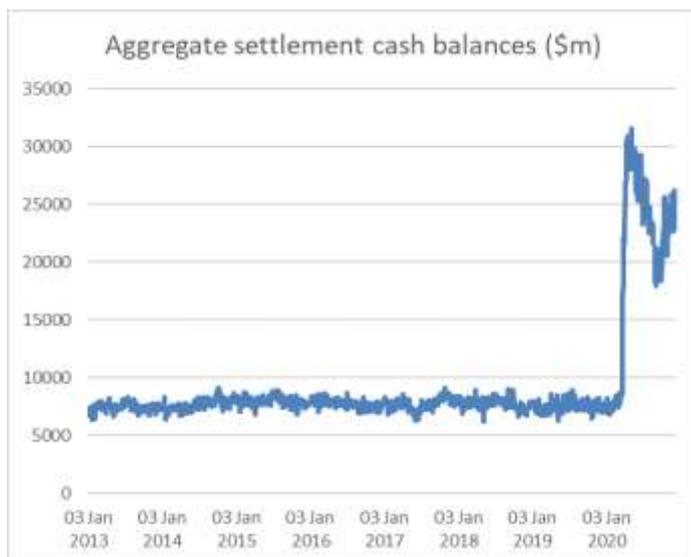
(There is a third possible counterfactual, that if the RB had done nothing - no LSAP, no further cuts to the OCR - the government would have done more with fiscal policy. Views will differ on the merits of such an approach, and I would only note that it would have resulted in an even higher exchange rate, further skewing the economy away from the tradables sector.)

So that is the Reserve Bank model. They claim to believe that they have had a great deal of effect. I reckon their argument isn't particularly convincing, on either of the two RB counterfactuals. But I don't find that very surprising because I agree with their chief economist (the pre 16 March version) that - absent crises in specific asset markets - asset purchase programmes just don't make that much difference in and of themselves. That was also, as I read it, the general view of (say) the Fed Reserve's QE2 and QE3 programmes in the years after the previous recession (QE1 was in crisis conditions).

But what about all that "money printing" (not my words note). In the popular press, even the bits that try to focus on matters RB, we are told that the RB is doing \$100bn of "money printing", evoking images of Weimar 1923 or Zimbabwe rather more recently, when things collapsed into hyperinflation, aided and abetted by the respective central banks. All that "money printing" just must be doing something. And what, for example, about all the "money" freed up for the people who are selling bonds to the Reserve Bank?

Mostly these people have simply got very much the wrong end of the stick (and seem oblivious to the experience in, say, the United States over the last decades).

In substance, all that has happened with the LSAP programme is that the Reserve Bank is buying one lot of government liabilities (typically yielding a bit under 1 per cent) and issuing in exchange a whole lot of central bank (itself part of govt) liabilities. Those liabilities? When the Reserve Bank buys something it pays for those purchases by crediting bank settlement accounts at the Reserve Bank. These settlement account balances are liabilities of the Reserve Bank (and thus of the wider whole-of-government). And, under a policy change also announced back in March, every single one of those balances in the settlement accounts - \$25bn or so now, up from \$7bn at the start of the year - earns an interest rate equal to the OCR (0.25%). So the Bank has purchased lots of bonds, and in exchange issued lots of deposits. The LSAP is really just a great big asset swap scheme, and when you swap one lots of govt liabilities earning just under a (fixed) 1% for another lots earning 0.25% (but repricing whenever the OCR changes) one wouldn't normally expect a big macroeconomic effect. And we are not seeing one<sup>3</sup>.



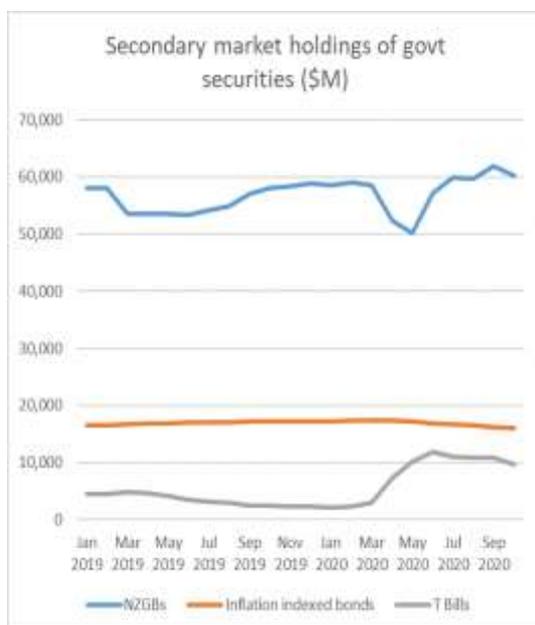
<sup>3</sup> Again time/space preclude developing the "why not just write off the RB bond holdings?" issue. Suffice to say, doing so would make no macro difference at all: the public sector's debts to the private sector would be unchanged (and the RB would eventually simply need to be recapitalised).

(What the LSAP is doing is generating a high level of refinancing risk. Instead of the wider Crown's net debt issuance this year being very long-term - which would appear to make sense when real interest rates are low – the net issuance (incl settlement cash and T bills) has been very short. If interest rates rise, Crown financing costs will rise a lot. I wouldn't to overplay the point, since most likely a significant rise in interest rates would accompany a much stronger nominal economy, but it is self-evidently an optimal financing strategy.)

Some observers seem to have in mind a model in which banks are strapped for cash and so boosting total settlement cash balances eases the constraints on their lending. But that isn't the RB story, and it bears no relationship to reality. Banks are actually awash with cash, are earning a reasonable (risk-free) return on those balances, and actually the DMO has been issuing more T bills than usual to reduce settlement cash balances (but again, this is just another swap, of little or no macro consequence). The constraint on lending this year has not been access to cash, but creditworthy demand from potential borrowers and the willingness of banks to lend into a highly risky environment. The RB's credit conditions survey backs up that story.

(Of course, it might have been a bit different if we were in some alternative world in which the RB was buying govt bonds yielding say 10%, and issuing new settlement cash earning 0%. Banks really would be desperate to get rid of excess settlement cash and their individual attempts would have driven retail and wholesale rates much lower. But that isn't 2020's world - nor was it the scenario in the US in their QE2 and 3 exercises.)

Oh, and did I mention that the private sector has not been a net seller of bonds to the Reserve Bank. There has been some drop in foreign holdings of NZ govt bonds this year, but most domestic holders - funds managers, pension funds etc - have just gone right on holding much the same bonds they always had. I'm a trustee of two pension schemes, and I've seen no sign of any of our professional managers or advisers suggesting we reduce our holdings. And we haven't done so.



If there is more money in the pockets of firms and households - and the money supply numbers do show a bit of a lift - it has almost nothing to do with monetary policy, and everything to do with fiscal policy. The government spent very heavily in the period from March to August/Sept, primarily for income support through the wage subsidy scheme, but also arrangements like the (heavily subsidised) small business loan scheme. You might or might not think those schemes were sensible

– I generally support what they were trying to achieve – but they were what supported purchasing power in the economy. Much of that spending has now come to an end, and automatic stabilisers are also reducing the size of the deficit as the economy has recovered.

To sum up, re LSAP, there simply isn't huge amounts of money slushing round urgently wanting a new home. There was lots of temporary income relief - and that was fiscal policy - and there was an increase in settlement cash balances (and T Bills), but banks are getting what is essentially a market return on those holdings. To repeat, and here I'm with the RB, if the LSAP works it will have done by its interest rate effects. Unfortunately, those seem likely to have been modest, especially at the points on the yield curve where it really might have helped.

Unfortunately, the Bank's rhetoric - about all the big effects their measures are having - has fed a story that somehow monetary policy is to blame for recent house price rises, and even that monetary policy might be able to usefully do something in response. As it is \$100bn sounds like something big. In fact, it isn't.

### **Funding for lending**

The Bank's latest clever wheeze - which, as I will argue, has also created problems for them - is the Funding for Lending Programme, finally put into operation this week

Under this scheme, the Bank offers to lend (secured on good collateral) to banks, at the OCR, up to 6 per cent of their total funding (4 per cent as of right, 2 per cent if their lending increases). In total that could be \$28bn of loans.

Again, to the extent that it does something useful it will work wholly and solely by lowering interest rates. Don't just take my word for it: the Bank has said much the same thing. I don't expect there will be much borrowing undertaken - and the Bank's Dep Gov also said the same thing - but the willingness to lend, with no onerous conditions, will have tended to put downward pressure on short-term interest rates. One of the oddities of the New Zealand market had been how high retail deposit rates had been relative to wholesale rates (and the OCR). Some of the explanation will have been regulatory - the RB's core funding requirement - and some about rating agency etc preferences for retail funding. Whatever the reason, for any given OCR it held up overall bank funding costs (and more so than in most advanced countries). The RB had sensibly made the CFR non-binding back in March, and yet retail rates had still been slow to come down (even though the Bank had offered a little-used term auction facility). Talk of the FFL programme seemed to help give banks the comfort to each bid a bit less aggressively for term deposits (and perhaps for wholesale offshore term funding too), lowering effective funding costs relative to the OCR.

Against the backdrop of the economic recession - here and abroad - and the uncertainty about the global climate over the next couple of years, and given the Bank's refusal to cut the OCR, the FFL has had some useful effects. But (a) they are probably quite small (perhaps cutting funding costs 20-30 bps) and (b) there is unlikely to have been the exchange rate effect one might have seen with an OCR cut. The Bank claims the FFL scheme will help make negative OCRs more effective, if adopted, but at present the FFL acts as a second-best substitute for a lower OCR, rather than a complement to it. Perhaps that will change next year, but only time will tell.

But the Bank made a rod for its own back with the naming of the programme. It fed a media narrative that somehow banks were cash-constrained (see above) and that (up to) \$28bn of new lending would flow to banks and straight through in increased lending to firms and households. In other words, that somehow this was going to be a highly inflationary programme, and altogether

rather reckless. The scheme seems to have been named after a government scheme done through the Bank of England after the 2008/09 crisis, at a time when - for some banks - funding really was a constraint. Those circumstances bore little or no relationship to the position in 2020 New Zealand. Call it a supplementary short-term interest rate management tool (really just an expansion of how the ORRF works at the top of the OCR channel), and that particular problem would have been solved.

The title also led to the weird political debate about whether funds under the FFL should be tied only to increases in business lending. Had that approach been adopted – and fortunately it was not, the scheme would have been little used even in influencing bidding behaviour in the deposit market. Business credit is flat or falling because banks are wary about lending at present, and perhaps especially to the sort of borrowers who are keen to borrow at present - in a recession of uncertain magnitude, depth and length. Funding (for banks) isn't just a second-order issue but a non-issue. Sadly, it was a problem the Bank brought on itself.

## **Housing**

Where does housing fit into all this?

First, it is worth remembering how much mortgage rates have fallen in typical past New Zealand recessions. Several hundred basis points. And by contrast, how much mortgage rates have fallen this year - between 75 bps (floating) and 100 bps. In past recessions, despite those falls, house prices have typically fallen back a bit (down 15% in real terms in 2008/09).

Second, as discussed above, despite the media narrative, it is not as if the banks are falling over themselves to lend because of all the “money printing” the Reserve Bank has done. Settlement balances have risen, but banks are fully remunerated on those (risk-free) deposits. And we know that banks themselves have been quite cautious in their lending standards (many potential borrowers have complained of it) - understandably so when no one knows quite how this recession will unfold.

So what is different this time? Seems to me there are three things:

- The mortgage holiday scheme, without which we'd have seen a lot more forced or semi-forced sales this year,
- The relatively generous income support through the Covid initiatives, again without which we'd have seen more forced sales this year, and
- The relaxation of the LVR restrictions announced in March (which the Bank is now consulting on unwinding).

I suspect the third of these is most important, and the resulting house price surge - unlikely to continue for long - is just another unforeseen consequence of the Bank's resort to financial repression over the last decade. It made sense to relax the LVRs, both because without it there would have been a clash with the mortgage holiday, and because LVRs were justified on the grounds of overly-loose lending standards, and going into a potentially severe recession it was only reasonable to assume credit standards would tighten (as they have). But lift the lid off financial repression and it is hardly surprising that when any sort of normality returned (back to “Level 1” conditions) quite a lot of lending would take place that was previously outlawed. We saw exactly the same sort of thing when controls were lifted in the mid 80s. The problem wasn't lifting the LVRs this year but having imposed them in the first place.

Things move fast in Covid 2020, and perhaps you'd be forgiven for having forgotten that only 2-3 weeks ago the Minister of Finance - under huge political pressure for the government's structural failures on housing - tried to shift some of the blame to the Bank, writing an open letter to the Governor. Mostly it was just political window-dressing, an attempt to shift the blame. But again, the Bank hadn't helped itself this year, with (a) all the big noting about how much "money" they were putting into the system, and (b) public comments from at least one MPC member who seemed to welcome higher house prices as some sort of "good thing" for the wider economy.

The Governor's own initial response was terse, and not entirely honest, but when all boiled down he was on solid ground. Monetary policy cannot sensibly be oriented around house prices, and if it were to be so this year, we'd have had higher real interest rates, a weaker economy, higher unemployment, and still-lower inflation. By contrast, house price inflation is better addressed directly: as the Bank itself had pointed out quietly in its Nov MPS, by fixing the land-use restrictions that make urban land astonishingly expensive in such a land-abundant country. (His fuller response out yesterday also correctly pushes back on the monetary policy connection, but offers the Minister a way out, by suggesting some use of the government's powers to direct the Bank to have regard to certain issuing in exercising its financial regulatory powers).

### **Overall macro position**

There are plenty of people around who purport to believe that the Bank has done too much this year. Not one of them has come out and been willing to suggest that they think the unemployment rate should have been higher still. I guess that isn't too surprising, but it helps to focus the issue nonetheless....

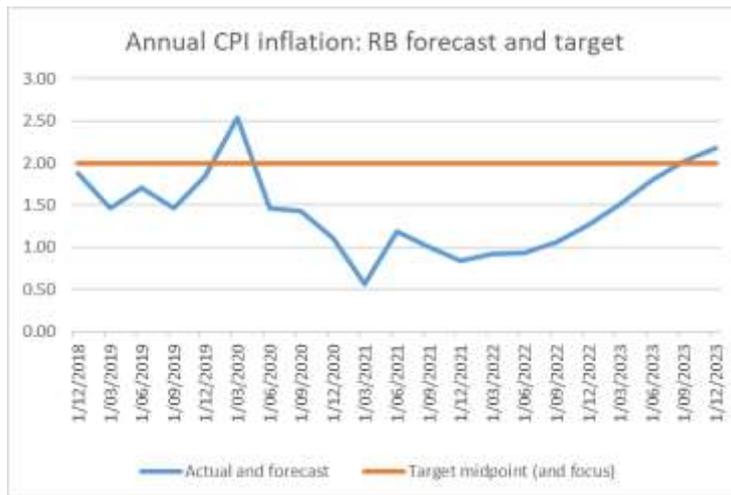
It is also true that the economic rebound has happened a bit quickly, and perhaps more strongly, than many (including me) had expected. That is good news, especially if sustained (tho not ANZ's pick of a "double-dip recession next year), but (a) the unemployment rate is still rising, and (b) most commentators think it will be at least a couple more years before we get back on a pre-Covid path of real GDP. The virus needs to be reduced to a minor global issue, confidence and certainty return, and all the time we will be dealing with the real losses of wealth that have occurred this year - often crystallised in much higher government debt to GDP ratios - and the adjustment, incl fiscal adjustment, likely in response to that.

But I'm not a macro forecaster myself these days, so look instead at the RB's own most recent MPS last month (I wrote about some of it here [Not doing their core job | croaking cassandra](#) )

*In those official projections, inflation does not get back above 1 per cent – the very bottom of the target range – for two more years, at which point it will have been more than 2.5 years since the Covid-related severe downturn got underway. It is three years from now until inflation is forecast to get back to 2 per cent.*

*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.*

*And altho these are the central forecasts, the Bank has stressed that they see the risks skewed to the downside (a point reiterated in the Governor's Aus speech last week).*



And - for all the fevered talk in some quarters about inflation risks from the LSAP and FFL programme - inflation expectations - whether survey measures or market price measures - have **fallen** (and market price measures, from the market for indexed govt bonds, were well below target at the start of the year).

The Bank has often talked about trying to adopt a “least regrets” approach to monetary policy. It was even their rhetoric last year, when one could argue they were moving pre-emptively. The gist of the story was that they would prefer to find out that they had eased a bit too much, with core inflation ending up in the upper part of the target range, than to do too little and end up with unemployment higher for longer than it needed to be, and inflation undershooting. It is a laudable approach, in principle. It bears no relationship to what the MPC has actually been doing this year.

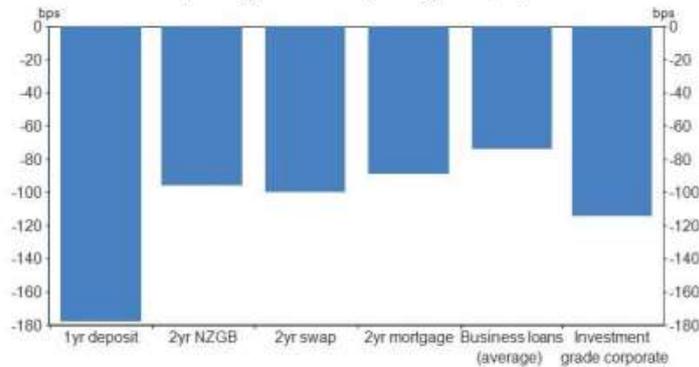
You can tell that. The Covid slump has been less bad than the Bank expected, and the recovery to date faster. And yet they are still forecasting v weak outcomes, with net downside risks, even with all the stimulus (OCR, LSAP, FFL) they claim to have thrown at the economy.

There are no tough tradeoffs - from a mon pol perspective. The Governor himself has pointed out that unemployment and inflation outlooks have both pointed in the same direction. But they haven’t done anywhere near enough: on their own (a) numbers, and (b) framework (“least regrets” and all that).

Perhaps that claim surprises you. If what you are bothered about is house prices, see the earlier discussion, but also refer your concerns to govts that refuse to fix the land use laws. House prices aren’t the job of the Bank.

But the Governor likes to talk about how much the Bank has done. He was at it again in his Aus speech last week with this chart

**Figure 8: Change in New Zealand interest rates**  
(change since beginning of 2020)



Source: Bloomberg, interest.co.nz, RBNZ

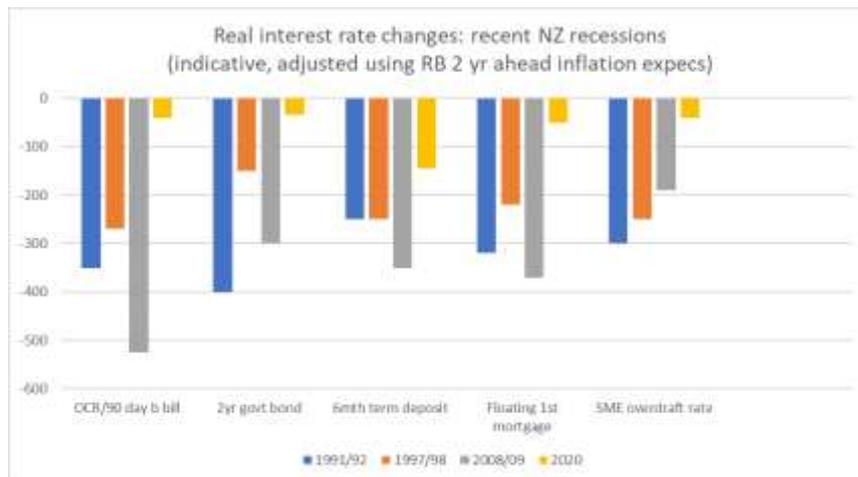
Note: Data for business loans reflects the change in the average interest rate on outstanding business loans. Other rates are based on advertised and market rates

On first blush, those big bold bars might look quite impressive. Deposit rates have certainly fallen a lot. But even with all those interventions, 90 day bill rates are down around 75bps and 2 yr govt bonds perhaps 95 points. Actual bank lending rates are down by a bit less.

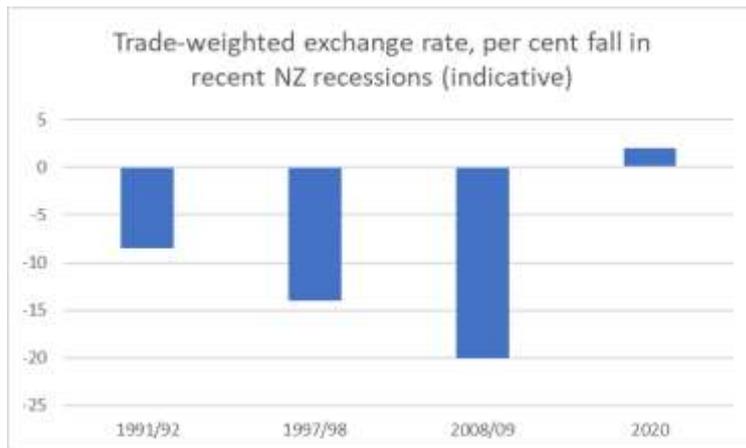
And these are nominal interest rates. But when economists think and talk it is mostly real interest rates that matter. And surveys suggest expectations of inflation have fallen perhaps 30-40 basis points since Covid broke. In other words, real mortgage interest rates might have fallen 50 basis points. That's a bit better than nothing, of course, but just not very much at all.

Oh, and the Bank rarely mentions that the real exchange rate is higher now than it was at the start of the year. Perhaps their mon pol interventions really do mean it is quite a lot lower than otherwise, but that is no comfort to the NZ economy: people operating in it are facing real interest rates that haven't fallen much, and a real exchange rate that has risen a bit. You'd think this was some small shock, a minor downturn. (And remember that it is the Bank which stresses that int and exch rate effects are how their policy interventions are supposed to work.)

By contrast (and using a slightly different set of rates, because some collections only start recently), here is a chart comparing how real interest rates have adjusted in recent NZ downturns



And here is the trade-weighted measure of the exchange rate



There just isn't much there. Lots of activity, lots to talk, signifying not very much. Not much, in short, stabilisation or stimulus being provided by monetary policy.

(The RB can't control the mix - between int rates and the exch rate - but they have full control over the overall amount of stimulus, and it just isn't much.<sup>4</sup>)

### How should we evaluate the Bank's performance?

We always have to be careful, when evaluating government agencies, not to hold them to unreasonable standards. In this talk I've tried to ensure that I use either information that was available to them when they made decisions, their own rhetoric and arguments, or common international central banking practices and standards. We can't blame the RB, for example, for not pre-emptively easing a year ago in anticipation of a pandemic no one - no central banker anyway - could reasonably know about.

But we, and should, criticise them for:

- The failure to recognise and respond to the emerging risks early (monetary policy works with a lag, risks around being near the lower bound were well known),
- The failure, having decided that the negative OCR was a preferred option, to have ensured the bulk of the system was operationally ready (almost inexcusable, and has meant we have had monetary conditions tighter than otherwise for most of the year,
- The failure to operate as if "least regrets" was actually guiding policy - the evidence for this not being my independent analysis, but their own numbers,
- Falling back on exuberant spin regarding the impact of the LSAP, when realistically the effective impact is likely to have been small,
- Opening the way to the "\$100bn money printing" rhetoric by adopting LSAP rather than a mod-point on the yield curve target (as the RBA initially did, and even the LSAP the RBA is now doing is much smaller relative to the size of the economy),
- Allowing the (second-best) sensible FFL instrument to also be framed as some dangerous money printing exercise,

<sup>4</sup> And here it might be fair to note that this is true of many other central banks too. Monetary stimulus in this downturn is very modest by past standards, as all central banks seems to have allowed themselves to be bewitched by the respective lower bounds, not having used the time, to remove or markedly ease those lower bounds, to enable the sort of "deeply negative" policy rates that people like former IMF chief economist Ken Rogoff has called for (and I have called for here).

- Lack of serious transparency - whether the utter refusal to publish background analysis/research behind the mon policy choices/instruments, even in extremely unsettled times and when the rest of govt was being proactively transparent, or the continued invisibility and silence of the non-executive members of the MPC, and
- The lack of effective communications and framing. There have been few speeches all year, hardly any published research, nothing from the non-exec MPC members. Instead, they've largely left the framing of issues to critics - notably the ones who think the Bank has done too much and is to blame either for house price inflation and some looming general inflation. There has been nothing authoritative from the Bank, and they seem constantly to have been running to catch up.

It has been a poor performance, that reflects poorly on all those involved: the Governor, his senior staff, the invisible non-exec MPC members, the Board (paid to hold management to account) and the Minister with responsibility for management and the Board.

Of course, it is fair to ask how much difference a better monetary policy - substance and presentation - might have made. By now, perhaps not a lot substantively – the mon pol lags are longer - but into next year it would have helped lay the foundations for a strong recovery, a lift in inflation and rapid return to full employment (we can't afford the 10 years it took after 2007). And, agree with them or not, the RB would stand higher in informed opinion, and if we value the idea of an operationally independent central bank, that would have to have been a good thing. It would truly have been a least regrets strategy.