

Should have done better: monetary policy in Covid times

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Michael Reddell¹

Thank you for the invitation.

Introduction

Parliament asks the Reserve Bank to keep unemployment as low as possible, consistent with inflation remaining around 2 per cent over the medium-term.

In my talk this morning I'll review a number of strands of their performance over the last 18 months:

- How well prepared were they?
- How well did they respond?
- What impact have their various monetary policy interventions had?
- Why have the economy and house prices developed as they did? and
- Where to from here?

But right upfront I want to stress that extreme uncertainty dogs everyone trying to make sense of the macroeconomic situation. That shouldn't be a surprise: we've simply never had something quite like Covid (despite all the pandemics in centuries past). Even untangling the last year - things we now know about - remains challenging.

Preparation

Monetary policy affects inflation and unemployment only with a lag. Ideally, then, they want 12-18 months' notice of shocks (don't we all?). But Covid burst upon us and much about how events unfolded took most people by surprise.

Despite their best efforts, central bank - and other macroeconomists - are pretty hopeless at picking (any of) the big swings (up or down) in economic activity. So, they have to be prepared, have their tools ready, and be prepared to move quickly and decisively.

The Bank scores poorly here. The main monetary policy tool for many years has been the Official Cash Rate (OCR). It is a great instrument - adjust one small overnight interest rate, with no regulatory imposts or complications, no discrimination among parties, and monetary policy "gets in all the cracks". Retail lending and deposit rates adjust, the exchange rate adjusts. It has a track record of effectiveness.

But it was clear years ago that the next significant downturn could be a problem. As early as 2012 Alan Bollard had commissioned a report on how we'd cope with the next serious downturn. In a typical recession the OCR had been cut perhaps 500 basis points, and by 2012 our OCR was only 2.5

¹ Throughout a Reserve Bank career spanning 32 years (with interludes at other agencies here and abroad), Michael Reddell was heavily involved in monetary policy and the associated economic analysis, including 20+ years on the key internal committee advising the Governor (then sole decisionmaker) on the OCR. These days he is semi-retired and writes about macroeconomics and related policy issues at www.croakingcassandra.com

per cent. The internal working group recommended that steps be taken to ensure that our own systems and those of the banks were ready to cope with negative interest rates².

But nothing happened. The Governor was telling markets and the public that a negative OCR was his preferred tool when the next bad shock hit but it wasn't until the very end of 2019 that anyone at the Bank thought to check that the banks could cope³. They couldn't. And so, despite 10 years' advance notice, the MPC's preferred monetary policy tool for responding to a severe economic downturn just couldn't be deployed. It was an astonishing oversight⁴.

Response

The Bank was slow to recognise the severity of what we were facing last year. They weren't alone in that but as late as late-February 2020 the Bank was still openly talking up the economic prospects for 2020, even as the ground was already falling away under them.

But reality finally began to dawn.

On 16 March the OCR was cut by 75 basis points (to 0.25 per cent). This was still a week out from the New Zealand "lockdown" but uncertainty was escalating, share prices were falling, and domestic and foreign travel was rapidly dropping away. It was pretty much a textbook prescription, if a little late.

But there were two odd features about even that announcement:

- The first was that the OCR was not cut to zero. The MPC told us they believed they could not take the OCR negative, but there was absolutely nothing to have stopped them going to zero. They simply chose not to, and didn't explain themselves then or subsequently. Every little helps (substance and signal),
- Odder still was that the MPC firmly committed not to change the OCR for the subsequent 12 months.

The best guess about what was going on - they've never explained themselves or released the relevant documents - is that they wanted to offer an assurance that they wouldn't be champing at the bit to **raise** the OCR as soon as something like normality returned. That sort of "forward guidance" may sometimes have a place when things are relatively settled, but it was utterly indefensible on 16 March 2020 when neither the Bank nor anyone else had any basis for knowing quite how things would unfold and what might be needed. Not surprisingly, I'm not aware of any other central bank that made any similar sort of commitment.

Just a week later the situation and outlook had deteriorated markedly further. And that led the MPC down the path of "unconventional monetary policy". Here again, they weren't very well prepared (the papers they promised⁵ on the various unconventional policy options never were released). And

² Having concluded that the OCR could probably be taken as low as perhaps -0.75 per cent before it start to lose effectiveness, as people/institutions converted deposits into physical cash.

³ And so papers released under the OIA later confirmed,

⁴ They belatedly got onto dealing with this and by the end of 2020 - when it was no longer needed - we were told that the OCR could, if needed, now be taken negative. The RBA and Bank of England had also not made these preparations, but then the RBA Governor is on record as opposing the use of negative interest rates (for reasons never made clear).

In addition to this specific failure, and although various academics and advisers had been talking for years about dealing with the effective lower bound on nominal interest rates itself - to help provide additional firepower in severe downturns - neither our Reserve Bank nor any of their peers abroad had done anything about that in the intervening 10 years either.

⁵ In a speech the Governor delivered as late as 10 March 2020.

just a few days before the crisis broke over them, their chief economist (an MPC member) had been speaking at a public seminar, playing down what quantitative easing had to offer.

The Monetary Policy Committee used two main “unconventional” instruments:

The first was the Large-Scale Asset Purchase (LSAP) programme under which they’ve bought \$53 billion of government bonds (and a few local government bonds) on market, and got a government guarantee to cover any losses.

The second unconventional programme was launched much later in year when they thought monetary policy had not yet gotten enough traction, the Funding for Lending programme, under which they offer to make medium-term secured loans to banks (only) at the OCR interest rate.

A place for monetary policy?

Sometimes it has been suggested that monetary policy was simply never a suitable tool for Covid. After all, it is noted that monetary policy works with a lag and some needs are immediate. Other note that while monetary policy might be good for demand shocks (when willingness to spending is unexpectedly weak) no one has ever suggested it was much good in managing supply shocks.

There is something to this. When, for example, the government simply ordered most of us to stay home last April, shut the border and shut most shops, of course GDP was going to fall. That was an intended outcome, not something monetary policy could or should try to do much about. Monetary policy couldn’t replace the incomes of those unable to work, and it can’t do much about supply-chain sourced reductions in economic activity either.

But the view that there would be big hits to private demand also seemed reasonable. Tourists couldn’t come, foreign students couldn’t come, and everyone - but notably people considering business investment – faced heightened uncertainty about how long borders would be closed, how long lockdowns would last or how often they’d return. Add to that people noted that NZ commodity prices typically fell - often a lot - in global downturns. Again, it seemed reasonable to expect they would this time. Oh, and quite rationally one would have expected bank lending standards to tighten up during a downturn, and especially one with as much uncertainty as there was around Covid. Anecdotes, and the Bank’s credit conditions survey, suggest that is exactly what happened.

So the idea that macro policy - including monetary policy - would need to provide a lot of stimulus, to help hold inflation up and unemployment down (even beyond the immediate lockdown period) wasn’t terribly controversial at all.

If anything, on the Bank’s own forecasts, if there was a puzzle it was more about whether enough (effective) was being done. Why do I say that? Well, take a look at the economic projections they published even late last year which have inflation consistently undershooting the target for several years, and unemployment staying uncomfortably high for a considerable period of time. Last August, for example, when the worst of New Zealand lockdowns was over, the Bank expected that inflation now would be a touch under 1 per cent.

[Figures 1 and 2]

Policy impact

There were four elements to the monetary policy response last year. What impact did those measures have?

The OCR cut did about as much, or as little, as you’d expect it to do. Other short-term interest rates fell quite quickly, and although the exchange rate didn’t change much, had the Reserve Bank not cut when other central banks were cutting the exchange rate might well have risen. But (a) 75 basis

points wasn't much (cf past downturns), and (b) for quite a while any gains were offset by a sharp fall in public/market expectations about future inflation. Real rates are what matter.

That strange pledge not to change the OCR for a year ended up rather lost in the wash. It turned out not to have mattered too much because (a) economic conditions rebounded faster than the MPC had expected, and (b) because the MPC made up for it by introducing the Funding for Lending scheme.

[Figure 3]

Given that MPC refused to take the OCR lower, the funding for lending scheme was a fairly effective second-best intervention. Not much lending has been done, but banks knew they could borrow from the RB, and that gave them the confidence to bid down term deposit rates closer to the OCR. It wasn't ideal, partly because it was banks-only and partly because it had no impact on the exchange rate but, devised somewhat on the fly, it achieved what the Bank was looking for it to do.

And then there was the LSAP.

It was launched amid a savage but brief global sell-off (rise) in bond yields - as share markets fell sharply - with lot of funds selling the easiest to liquidate assets (government bonds, abroad and here). The Reserve Bank entering the market helped stabilise the local bond market (which would have happened quite quickly anyway). But the main point of the programme was to ease overall monetary conditions, and in turn to support demand and underpin inflation.

Whether from the right or the left - or the technocratic middle (the market economists) - you hear tales about, for good or ill, the large impact of the LSAP. I have a minority view. My story reduces to this proposition: the LSAP was expensively largely irrelevant to anything that mattered macroeconomically in New Zealand.

Let me explain.

There has been lots of effort globally to work out just how much impact QE types of programmes have had beyond the peak liquidity pressures in financial crises. I've always been a bit sceptical and used to suggest to people that the enduring impact of QE couldn't have been that much since bond yields seemed to have fallen by much the same amount, relative to policy rates, in places like New Zealand and Australia - that had not used QE - as in places (like the US, the UK or Japan) that had⁶.

But now we've had a big experiment all of our own.

It often isn't appreciated that the LSAP largely involved a huge asset swap of two very similar assets. The Bank bought government bonds (no credit risk, earning a market (but low) interest rate, and in exchange it issued (paid for bonds with) Reserve Bank deposit balances (no credit risk) on which it currently pays a low (but market) interest rate. They were buying one lot of assets yielding under 1 per cent, and issuing in exchange another secure asset earning the OCR (0.25 per cent). You simply wouldn't expect an exchange of that sort to matter very much - to affect the economy much - and it didn't.

Sometimes you will see stories about bond buying affecting future monetary policy expectations, or portfolio balance effects, or straightforward settlement cash effect (the \$50bn+ the Bank paid for the bonds). But none of these stand much scrutiny in New Zealand over the last 18 months - banks,

⁶ At a general level this is consistent with the view of eminent monetary economist Prof Charles Goodhart in the Foreword to a recent book on QE, who acknowledges the effect in full-throated liquidity crisis but notes "In my view...the direct effect on the real economy via interest rates, either actual or expected, and on portfolio balance, was of second-order importance. QE2, QE3 and QE Infinity are relatively toothless." It also appears similar to a view enunciated last year by the Governor of the Bank of England.

for example, aren't constrained in how much they lend by the total amount of settlement cash - and to its credit, the Bank itself never seemed to put much weight on these arguments. They simply argued that the LSAP lowered interest rates and lowered the exchange rate. The LSAP was simply a substitute for the OCR.

Unfortunately, this story - superficially plausible as it may sound - also doesn't stand up to much

Perhaps - and I'm not going to argue the point - the Bank's bond-buying made some material difference to the 20-year government bond rate, perhaps even to the 10-year rate. They focused their purchases on these longer-term maturities.

[Figures 4 and 5]

But this isn't America. Nobody takes a 30-year fixed rate mortgage here, and the Bank's own data show that very few people even take a 5-year fixed rate mortgage. Most of the residential mortgage lending is either floating rate or fixed for 1-2 years, and business lending doesn't look much different - whether direct from banks, or through the corporate bond market where most longer-term borrowings are swapped back to floating rate. The OCR and the bank bill rate matter a lot, and so do one and two year swap rates, but **in New Zealand** nothing much beyond that matters very much⁷.

Interest rate differentials (actual and expected) between NZ and other countries influence the exchange rate, but typically it has been relatively short-term differentials (again, overnight to perhaps two years) that matter there too.

The LSAP didn't affect the OCR - after all, the Bank sets that directly. So it all comes back to whether the LSAP - heavily focused on buying long-term government bonds - made any material difference to 1-2 year swap rates. It isn't possible to know the counterfactual with 100 per cent certainty, but there is nothing in the relationship between the OCR and 1 and 2 year swap rates that is any different than one would have expected to see if told simply that (a) the economy was in a recession, (b) inflation was forecast to be very low relative to target for the next couple of years. The OCR would then be expected to stay very low against that backdrop, and the one and two year rates would embody those expectations. If there was any sustained LSAP effect at all it must have been tiny⁸.

So why all the hullabaloo?

Most of it, of course, is because house prices have gone crazy, with huge increases over the last year. But note that this is not a story exclusive to New Zealand. It is a highly unusual outcome, and I don't think it is yet even close to being fully understood.

Last March, the general expectation was that house prices would fall. I told myself that in the last recession house prices had fallen about 10 per cent - even with 575 basis points of interest rate cuts - and had taken five years to get back, in real terms, to pre-recession levels. This time there would be job losses, income losses, banks would tighten lending standards, immigration would be lower for a time. Against that backdrop, all that lower interest rates would do would be to lean against the

⁷ Long-term rates matter, of course, to the government (its debt financing costs) but no one supposes for the moment the government altered fiscal policy one jot last year because the 20 year bond rates was, say, 20, 30 or even 50 basis points lower than otherwise. And if it didn't change behaviour, it didn't change economic outcome.

⁸ Note that one of the other big problems with the Bank's story is that past estimates of the impact of higher government debt on interest rates are quite small. When he was chief economist at Westpac some years ago, the Governor did research suggesting that a 20 percentage point of GDP increase in net government debt, from a low base, would raise bond yields by perhaps 10 basis points (P Conway and A Orr, "The GIRM: A Global Interest Rate Model", Westpac NZ Institutional Bank Occasional Paper, September 2002).

losses. That was also the Reserve Bank (and Treasury) story. For a month or two it even looked as though that story was playing out. And then it didn't. That was a surprise, but it was neither intended, predicted, nor desired by the Bank.

People - particularly some journalists on the left - are keen to blame the LSAP. But there is simply no credible mechanism for it to have been a major part of the story. You hear over and over again about "printing money" as if the \$50 billion asset swap - remember I explained that was what it was - somehow involved the housing market. But pension funds or hedge funds that had owned bonds didn't suddenly start buying housing instead. All indications were that banks own lending standards remained tighter than they'd been - although the LVR restrictions had been temporarily (and sensibly) eased when the crisis began. And no one - repeat no one - suddenly had \$50 billion of fresh purchasing power - income - in their pockets.

My own story about what happened to the housing market - which has to be general enough to encompass similar experiences abroad - combines three things:

- Ongoing highly restrictive land-use policies imposed by councils, enabled by central government (when new land/houses are hard to bring to market any shock goes quickly into prices),
- The quite unexpected extent to which the loss of domestic demand for foreign tourism, export education etc was offset by additional local spending by New Zealanders (what people didn't spend on their overseas holidays, they spent on local holidays or renovations, or eating out or a new car or boat). There just wasn't the shortfall in incipient demand the macro community (and MPC) had expected, and
- The really big shift in fiscal policy. Attention is often focused on the wage subsidy last year, but this year's Budget tables show that even though that spending is long in the past the projected cyclically adjusted deficit for this year (21/22) is huge: 6 percentage points of GDP larger than just a couple of years earlier.

Throw in some reduction in interest rates - but the fall in the 2-year mortgage rate last year was no larger than the fall over the previous 18 months (when house prices had been subdued) - and perhaps what we've seen is less surprising.

[Figure 6]

There simply wasn't a big private demand shortfall for long and then the government massively boosted demand not by a one-off wage subsidy, but by swinging the Budget deeply into structural deficit. Unsurprisingly some of that additional purchasing power spills into house prices (as well as into low and falling unemployment and rising inflation).

Where do we stand now?

The unemployment rate is now 4 per cent and the inflation rate - the sectoral core measure the Bank tends (rightly) to focus on - is 2.2 per cent. Those are really good outcomes - first time in 10 years that core inflation had crept above the target midpoint. After the last recession it took 10 years to get unemployment back down, not 10 months.

But those outcomes to celebrate aren't much credit to monetary policy, since when the MPC was setting the policy that was having an effect now they thought their policy was consistent with much worse outcomes⁹.

⁹ And all this despite their "least regrets" enunciated framework, in which they claimed they'd rather have overshot the inflation target than continued to linger below the midpoint. Like much about the MPC over the last year, it seemed to be more about attempting to display virtue than acting substantively.

But where to from here? The MPC has belatedly terminated the LSAP. They really should be ending the Funding for Lending programme, which was explicitly a crisis programme, a stop-gap for when they couldn't cut the OCR further, and which was not operated on a competitively neutral basis. But more likely the next step is the OCR.

One possible reason for caution is that coming out of the 2008/09 recession, central banks (and markets) were too keen to start getting interest rates back to what was thought of as "normal". The RBNZ made that mistake twice, and quickly had to reverse themselves. But both times there was no sign of core inflation rising and the unemployment rates were still quite high, so quite different circumstances than we have now.

[Figures 7 and 8]

Some will doubt whether 4.0 per cent is the lowest sustainable rate of unemployment but it is getting pretty close to the cyclical lows of the last two cycles¹⁰. Wage inflation is rising faster than at any time since 2008, at a time when there is no productivity growth. But the real guide - especially amid considerable ongoing uncertainty - is core inflation itself. If it is above 2 per cent, and no one thinks it is about to drop back, then it is time to start tightening – not necessarily aggressively (there is no harm if core inflation goes a bit higher for a while, as it is likely to do), not part of some predetermined programme, but step by step, review by review, keeping a close eye on fresh data. They need to be tightening at least a bit faster than inflation expectations are rising (on which new data next week). And since the world economy could be derailed again, and fiscal policy (here and abroad) may start tightening, and very long-term interest rates are still at or near multi-decade lows, be ready to stop or reverse course if the data warrant that. The great thing about monetary policy is that when the data change, policy can be altered quickly and easily.

The same can't be said for fiscal policy. There are plenty of things only government spending can do. For example, income support to those rendered unable to earn because of pandemic restrictions. There are plenty of other programmes for which one might make a careful well-analysed and debated medium-term case for spending taxpayers' money on. But cyclical stabilisation policy is a quite different matter. Many fiscal programmes are – rightly or wrongly - hard to get underway, and slow to start (many of those "shovel ready" projects), some are easy to start but hard to stop. And almost all involve playing favourites, rewarding one group or another - with other people's money - according to the political preferences of the particular party in power. Fiscal announceables, once announced, are very hard to take back off the table.

By contrast, the MPC can and does act overnight, it can reverse itself, and it coerces no one, and picks no winners. Market prices shift and people and firms make their own choices whether or not more or less spending is now prudent for them. There has rarely been a better illustration of how much more suited monetary policy is to short-term cyclical stabilisation than the surprises of the last year.

Summing Up

How then should we evaluate the MPC's performance?

It is clear they were poorly prepared. There is really no excuse for that. It was always only a matter of time until the next severe shock came along.

When they finally began to appreciate the severity of the Covid shock their actions were in the right direction.

¹⁰ And quite a few measures this government has implemented (min wages, sick leave, public holidays, welfare benefits) are likely to have raised the NAIRU at least a bit

But they can't be credited with the good outcomes we are now experiencing – inflation and unemployment - because when policy was being set last year they expected their policy to deliver much worse outcomes, and did nothing about it. We can't blame them for the economic uncertainty, but they should be accountable for their own official forecasts and what they did with them¹¹.

The overall contribution of monetary policy to how things have turned out was pretty small. Mostly what has happened was down to private demand reorganising itself and holding up much more than expected - notably by the Bank – greatly reinforced by the really big swing into structural fiscal deficits.

As for monetary policy, the OCR cut was modest, and the exchange rate barely moved. The Bank claimed far too much for the LSAP, which was more noise than substance, and in the process they fed a narrative (“money-printing”) that made trouble for them and the government. If they really believe the LSAP is as potent as they've claimed, perhaps they could make a start on tightening by first selling ten billion of bonds back to market.

And if they accomplished little buying lots of long-term bonds at the very peak of the market in the process they have run up big losses. They dramatically shortened the duration of the overall public sector portfolio and then rates went back up. These are real losses - at about \$3 billion currently, four times the cost of the Auckland cycling bridge, without even the sightseeing bonuses.

We can't realistically expect policy perfection but we can and should expect authoritative, open, and insightful communications. But MPC's communications have been poor:

- They never published the background papers they promised.
- They never explained their weird 'no OCR change for a year' pledge.
- There has been no pro-active release of relevant papers (unlike the wider central government approach to Covid).
- They refuse to publish proper minutes - that actually capture the genuine uncertainties and inevitable, appropriate, differences of view, and which would allow individual members to be held to account.
- Little serious research is published, and insightful analytical perspectives are rare.
- From not one of them have we had a single serious and thoughtful speech on how the economy and policy are evolving.

In its first major test, the best grade we could give the MPC “could try harder, needs to avoid other shiny distractions, can't continue to count on good luck”. Oh, and just as well for them that the individuals aren't on the hook for those huge losses.

As with so many of our public institutions now, we deserve better.

¹¹ Note that just under three months ago, in the *May Monetary Policy Statement*, the MPC unanimously concluded that “medium-term inflation and employment would likely remain below its *Remit* targets in the absence of prolonged monetary stimulus” going on to note that “it will take time before these conditions are met”.

Charts

Figure 1

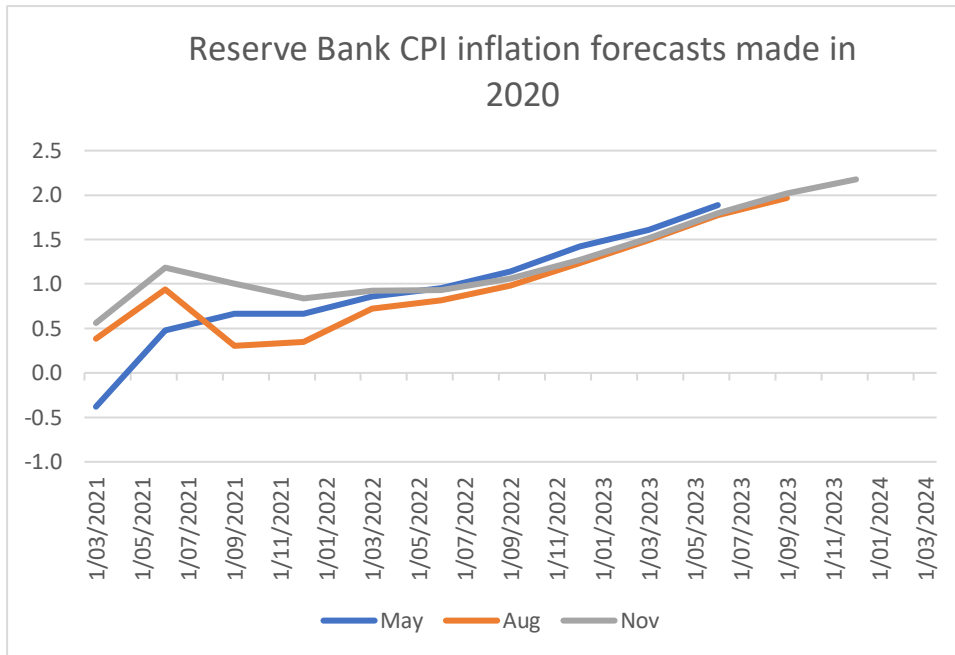


Figure 2

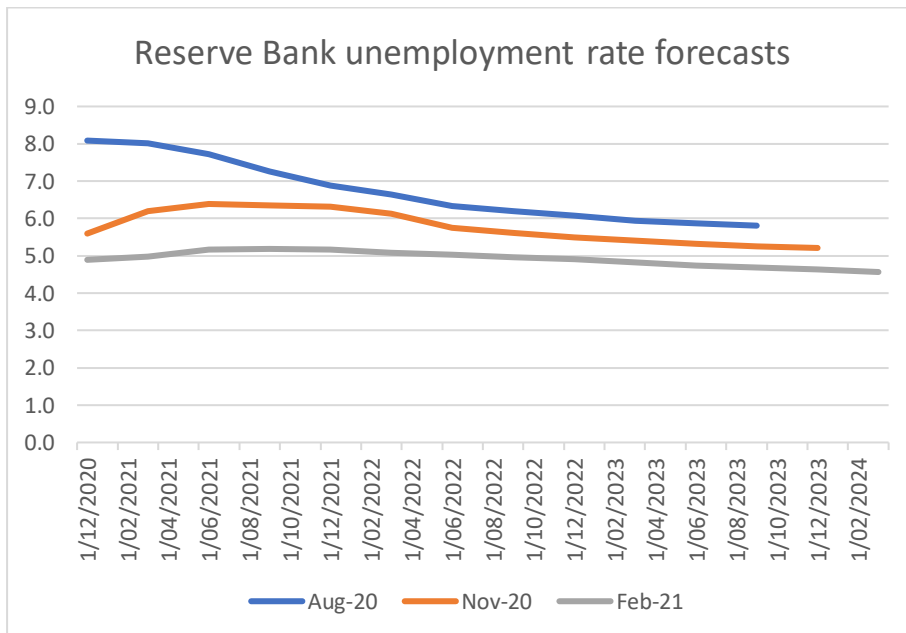


Figure 3

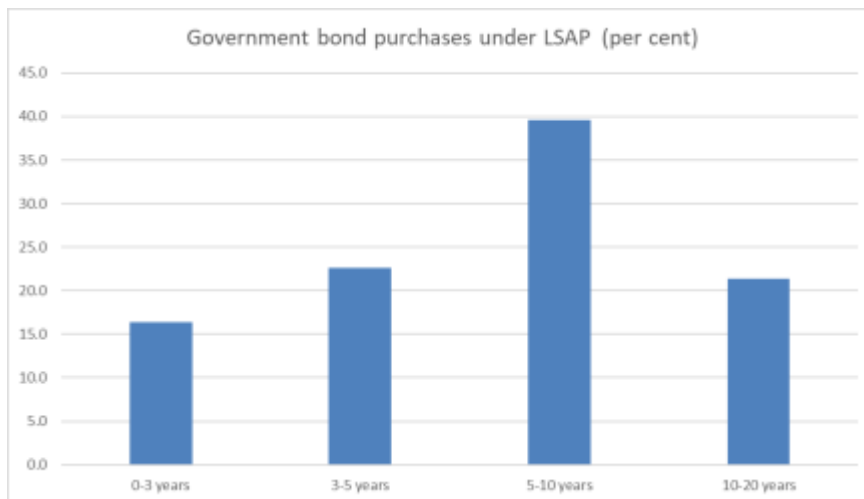


Figure 4



Figure 5

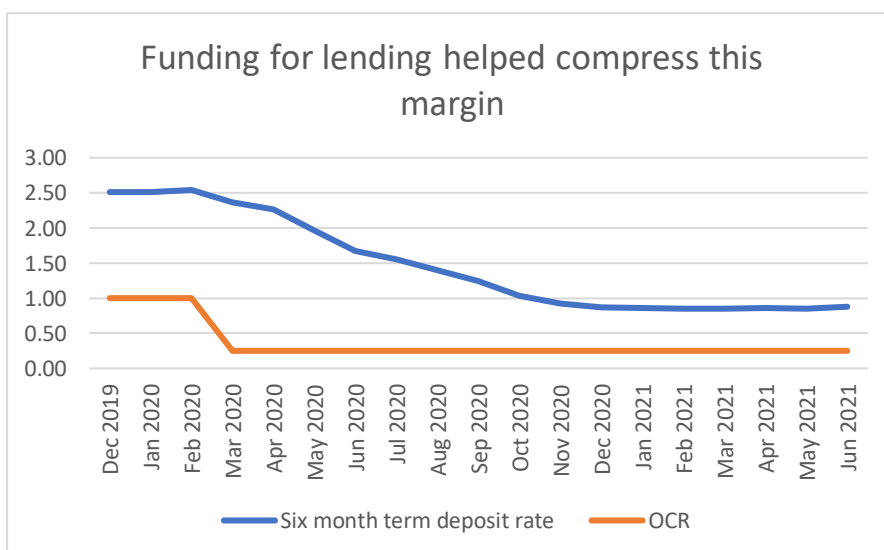


Figure 6

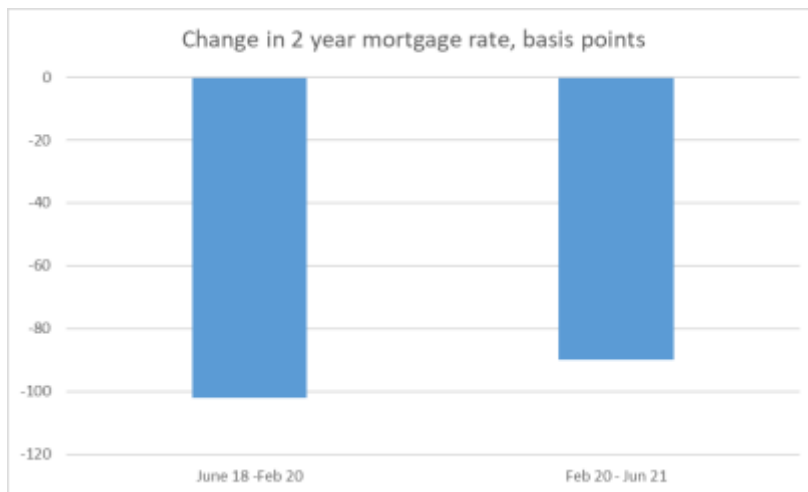


Figure 7

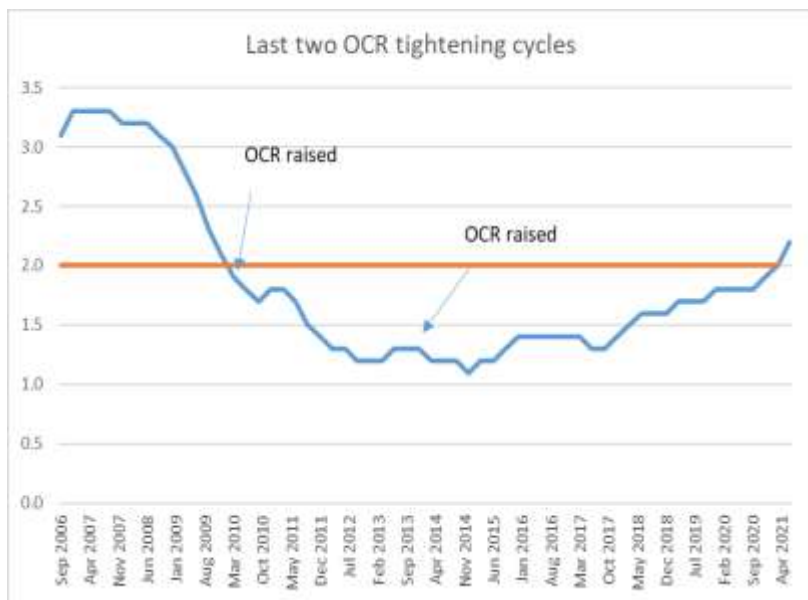


Figure 8

