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RESEARCH NOTE

The Unreserved Bank of New Zealand

Why unorthodox monetary policy needs boundaries

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I am suspicious of the idea of a new paradigm, to use that word,
an entirely new structure of the economy.

- Paul Volcker

Abstract

With its rate cut on 7 August 2019, the Reserve Bank of New Zealand surprised markets and sent a strong signal that unorthodox or unconventional monetary policy could be on the cards.

We argue that, especially under unconventional circumstances, predictability of the Reserve Bank is needed to retain its credibility, independence and reputation. In our view, this would also require changes in the wording of the Remit of the Monetary Policy Committee.

As the Reserve Bank takes on fiscal functions, its political neutrality and commitment to monetary stability, as well as maximum sustainable employment, need to be re-emphasised.

Introduction: Towards a new Reserve Bank paradigm?

When the Reserve Bank of New Zealand (RBNZ) cut the Official Cash Rate (OCR) by 50 basis points on 7 August 2019, *The Sydney Morning Herald* headline called it "Shock and Awe Kiwi Style".[1] The Australians, and the world, were shocked since the view had been that New Zealand had a relatively well-performing economy experiencing robust growth. However, the Bank had not earlier signalled that its own internal economic forecasts had turned so gloomy that it now considered an especially large cut would be needed to try to steady the ship.[2]

Observers had expected a cut, which had been signalled before. However, the magnitude markets had priced in was only 25 basis points. Against these widely held expectations, the RBNZ slashed rates to a record low of 1.00 percent. The exchange rate plummeted. Interest rates moved violently.

Market reactions demonstrated how unanticipated moves by a central bank can be dangerous. Why? Since the larger than anticipated rate cut was taken to mean that the RBNZ had been sitting on secrets regarding the weaknesses inherent in the NZ economy. Market participants would then ask themselves whether it was time to sell Kiwi assets and offload the currency.

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Such concerns can become self-fulfilling and lead to asset price collapses and financial crises. An unanticipated move by a central bank can do great harm.

More frighteningly still, the RBNZ seized the opportunity to prepare the NZ public for further monetary easing. Given the already low level of the OCR, this would mean moving towards unorthodox measures such as negative interest rates and large-scale asset purchases.

There is a subtle irony that the RBNZ is already flagging a revolutionary new phase of unorthodox policy while still not communicating its conventional policy transparently.

However, the lack of proper communication and the now-signalled move into uncharted territory go together. They are preparing the ground for the RBNZ to become more politically activist. It appears to be tiring of its previous life as the world's first Central Bank to explicitly target low inflation, backed up by top notch, behind-the-scenes, technocratic expertise. The Bank seems now to be seeking more limelight, with a desire to be known for advocacy of new causes, far beyond its previous justly narrow focus on price stability. Even if the Bank has no desire to stray beyond its traditional role in maintaining stable prices and reducing volatility, it risks being seen to be doing so.

There has always been a strong rationale behind keeping such a narrow remit. Central Banks, as the provider of currency, have enormous power. They are also constituted wholly by unelected officials.

When the RBNZ gained operational independence in 1989, the core task defined in the Policy Targets Agreement was to keep annual inflation within the target band (initially between 0 and 2 percent).[3] Over the years, amendments were made to emphasise avoiding undue instability in output, and, later, to provide a dual-mandate incorporating both maximum sustainable employment and inflation outcomes within the target band.

This is now changing to give way to a more activist approach. It is evident in the Remit of the newly established Monetary Policy Committee, which replaces the previous Policy Targets Agreements between the Minister of Finance and the Governor. The Remit begins by stating the Government's economic policy objectives (which include issues far outside the realm of monetary policy) and then states that monetary policy is meant to support these objectives:

> "**The Remit for the Monetary Policy Committee**
>
> **Reserve Bank of New Zealand**
>
> **The Government's Economic Objective**
>
> The Government's economic objective is to improve the wellbeing and living standards of New Zealanders through a sustainable, productive and inclusive economy. Our priority is to move towards a low carbon economy, with a strong diversified export base, that delivers decent jobs with higher wages and reduces inequality and poverty.
>
> **Context**
>
> Monetary policy plays an important role in supporting the Government's economic objective. The Reserve Bank of New Zealand Act 1989 (the Act) requires that monetary policy promote the prosperity and wellbeing of New Zealanders, and contribute to a sustainable and productive economy. Monetary policy contributes to public welfare by reducing cyclical variations in employment and economic activity whilst maintaining price stability over the medium term."

As the remit notes, monetary policy contributes to government objectives by reducing cyclical variation while maintaining price stability. That note of context should be read as constraining the range of activities available to the Bank in pursuit of the government's broader objectives.[4]

Under normal monetary policy circumstances, the statement of the Government's Economic Objective would then make little difference. The best way a Central Bank can support any reasonable objectives a government might have is by providing stable and sensible monetary policy.

However, once the RBNZ becomes an actor with quasi-fiscal reach through quantitative easing, it risks becoming an open question whether the Bank will take on the Government's broader economic objectives when implementing unorthodox monetary policy. Not everyone would understand that the restriction presented in the "Context" section, that monetary policy focuses on reducing cyclical variation and maintaining price stability, applies equally to conventional and to unconventional monetary policy.

The Bank has outlined that preparations for unorthodox monetary policy are occurring between itself and Treasury *"because some of it is fiscal policy operated through a monetary institution."*[5]

Even if it has no intention of straying beyond its traditional emphasis on price stability, the Bank's statements - in combination with its far wider potential activity should unorthodox monetary policy become required - may lead market observers to view the Bank's role as metamorphosising. The combination of a far wider remit and unorthodox monetary policy could even turn it into a political agency, or a sovereign wealth fund with added monetary policy responsibility, as we explain below. We hope that the RBNZ would explicitly rule out such options, well before any unorthodox monetary policy might become necessary.

Such confusion has been heightened by the rhetoric of the Minister of Finance. In a speech to the Productivity Hub in Wellington on 13 August 2018, Grant Robertson said that:

> "Our Tax Working Group and the reforms we are making to the Reserve Bank Act are an important part of setting the path to a more productive economy".

These comments notwithstanding, a grand consensus has emerged over the past half century that monetary policy can only positively affect productivity, or the "supply side", of the economy, to the extent that it is aimed at achieving low and stable rates of inflation. Why? Low and stable inflation rates help price signals in doing their work in terms of transparently signalling scarcity in the economy. Given that the RBNZ has already had a goal of price stability, in what other ways is the Minister suggesting that the Bank can be reformed in order to raise productivity?

We are concerned about this changing paradigm for the RBNZ. The purpose of granting the RBNZ independence in 1989 was to enable it to pursue its task of ensuring price stability without regard to political considerations. In this way, it was following international best practice, most notably by the then equally independent and stability-focused German Bundesbank.

Because of this commitment to a clear and single goal, the RBNZ was predictable as an economic actor. It was also highly respected and stood above politics. We believe that it might lose these features should the current path continue.

No surprises, please

The past quarter of a century has seen a consensus built over the need for central banks to be transparent with the communication of monetary policy. Transparency means that both the policy makers and the markets share the same information. "Shock and awe", the *Sydney Morning Herald* characterisation of RBNZ policy making, creates uncertainty, hampers the ability of businesses to plan and causes unfair wealth redistributions.

Pity the people who took out a fixed rate mortgage in the weeks leading to the RBNZ 7 August dramatic interest rate cut. If only they had known that the Bank was sitting on private information which it had not communicated to the markets and was about to be dumped on them.

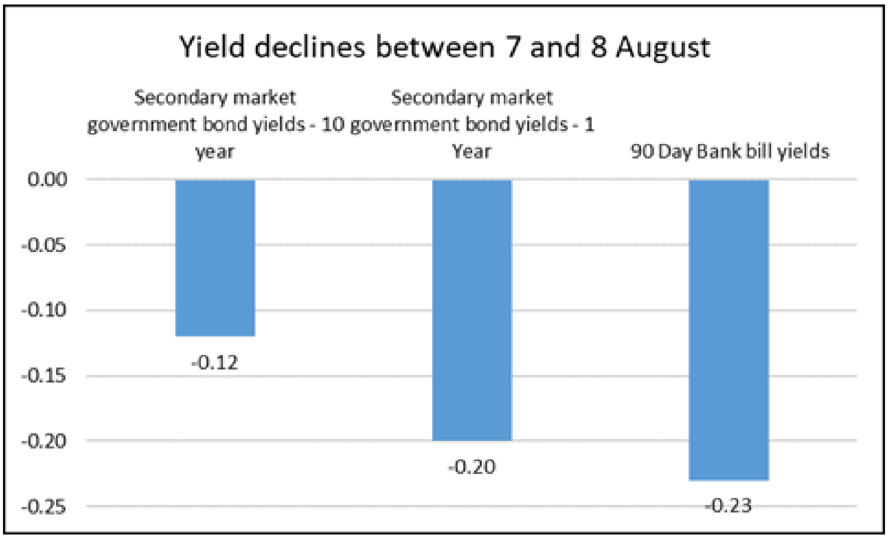

Figure 1: Interest rate drops over the time of the Official Cash Rate announcement on 7 August 2019 (Source: RBNZ Statistics).

Pity also anyone who just transferred foreign currency to New Zealand before the surprise OCR cut. The New Zealand dollar dropped by nearly two percentage points against the greenback, demonstrating that markets had not anticipated and priced in the decision.

Figure 2: Exchange rate fall over the time of the Official Cash Rate Announcement on 7 August 2019.

Good communication of monetary policy decisions implies that when the announcement finally comes, financial markets should not react. To improve transparency, one contender for Chairperson of the US Federal Reserve, John Taylor, has advocated the use of rules that are publicly available to help avoid surprises. An example is that the OCR should simply be increased when inflation rises and cut when unemployment rises. The rule tells one by exactly how much. Whether one endorses a Taylor Rule for New Zealand, or not, transparency and predictability have merit.

The RBNZ instead has embraced a highly discretionary approach to monetary policy, but one which requires knowing what is in the mind of the Governor and his new Monetary Policy Committee, who are largely a group of unknown quantities. Their "dovish" or "hawkish" tendencies are a mystery. That is no small issue considering how, in many countries, those kinds of qualities of new appointees to such a powerful Committee are the subject of endless national media attention.

The problems of highly discretionary monetary policy are alluded to in the following quote:

> "It was a surprise... but if you know Adrian, you probably shouldn't be that shocked by what he did, because that's his style", Juno KiwiSaver founder Mike Taylor told The AM Show (reported on Newshub on 13 August 2019).

The remarkable feature of the RBNZ's recent 50 basis point cut in rates was that 90-day bank bills fell by nearly a full 25 basis points during the announcement, proof that the financial markets were expecting a far more minor 25 basis point reduction. The extra 25 basis point drop was completely unanticipated and had not been signalled by the Monetary Policy Committee. Shame for those of us who don't "know Adrian" and "his style", nor the style of the others on the Committee.

It is still hard to understand the Monetary Policy Committee's rationale when the Minister of Finance was lauding in Parliament, on the same day as the RBNZ announcement, the high rates of employment and fact that unemployment was at an historic 11 year low. While the RBNZ targets its forecast, and its forecast called for those cuts, monetary stimulus particularly when coupled with the Bank's call for greater fiscal stimulus, was jarring.

In summary, how the RBNZ is implementing its "dual mandate" when making interest rate decisions is unfolding as a mystery, exacerbated by the fact that the Governor has rarely spoken to this issue.

Preparing for negative rates

In its May 2018 Bulletin, the RBNZ discussed options to introduce unorthodox monetary policy in New Zealand. At that time, the RBNZ stressed that there was no immediate need to move towards such a scenario.[6] The Bulletin went on to state that it would be worthwhile to examine the experiences made with such policies overseas and analyse in how far NZ's circumstances would suit measures such as negative interest rates, large-scale asset purchases and targeted term lending.

Having discussed some limitations on unconventional monetary policy (New Zealand's relatively small size, undiversified structure, and high composition of overseas ownership), the RBNZ then drew two main conclusions from its review:

> "New Zealand is fortunate that in wake of the 2008/2009 global financial crisis it was not required to reduce interest rates to zero, or implement unconventional monetary policies. We retain significant monetary policy space today. Nonetheless, with the OCR at historically low rates, it is appropriate that the Reserve Bank considers the issues associated with unconventional monetary policies in New Zealand, should economic conditions in the future require the OCR to be reduced to zero."

And:

> "The Reserve Bank would look to communicate well in advance of any of unconventional policies being implemented, so as to enable financial markets and the government to prepare.

> Indeed, as this article has discussed, the policy signalling channel is one of the most important ways these policies have their effect."[7]

These two points are important. First, the RBNZ regarded it as a positive that it did not have to follow other central banks down the path of unconventional monetary policy. Second, it saw the importance of communicating unconventional policies well in advance if it ever had to use them.

Considering the first point, it is astonishing how positive the RBNZ has been about the possibility of unconventional methods in its statements. Instead of emphasising their unprecedented character in New Zealand circumstances and their low desirability, the Bank has over time made them appear as if they were just another tool in their box – although it may be wishing to avoid unhelpful panic should such measures become necessary.

When Governor Adrian Orr, Deputy Governor Geoff Bascand and Assistant Governor John McDermott testified to Parliament's Finance and Expenditure Committee on 9 August 2018, Orr responded to a question from National's then finance spokesperson, Amy Adams. Adams had asked about the room for monetary manoeuvre in a low-interest rate environment. The Governor replied:

> "[M]onetary policy will have not just a zero bound; we have been spending a lot of time and doing work around what's called unconventional or non-conventional—which I actually believe is probably more conventional—monetary policy, which has been used globally. We haven't had to use it, because we haven't been in the same hole that everyone else is in."[8]

During the same session, both Orr and McDermott stressed that they did not regard New Zealand near a scenario in which unconventional tools would be needed. However, they stressed that the RBNZ was preparing for them as a contingency and, as the Governor's phrasing above shows, not one that would even be that unusual after all.

In June 2019, as part of their review of the Reserve Bank, the Reserve Bank and Treasury issued a Consultation Document 2B: *Safeguarding the future of our financial system - The Reserve Bank's role in financial policy: tools, powers, and approach*.[9] The document mentions that unconventional policy like quantitative easing could be used "in severe downturns".[10]

It then explains the overlap between monetary and fiscal policy in the event of unconventional monetary policy and put the following question for consultation:

> "If the Reserve Bank were to launch an asset purchase programme (quantitative easing), do you believe it should be able to make its own decisions to purchase government debt, but require ministerial consent to purchase other assets? Are there other implementation issues around asset purchase programmes that should be considered?"[11]

In August 2019, following the OCR cut and having released the Monetary Policy Statement (MPS), the Governor reiterated that the option of unconventional policy was developed. The timing was odd because the Bank's MPS revealed no severe crisis over the forecast horizon (Figure 3). Still, in an interview with *Newsroom* editor Bernard Hickey, the Governor expressed his preference for negative interest rates over quantitative easing.[12]

We can read his statements in two ways. In the literal sense, he says that negative interest rates would be less difficult to implement than quantitative easing. Between the lines, however, the message is to legitimise the use of either of these forms of unconventional policy by flagging their future use. Read this way, a preference statement like this is a strong signal that unconventional methods are likely to be used soon. It is the kind of signalling that the RBNZ had started with its May 2018 Bulletin and explained to the Select Committee in June 2018.

	Actuals								Projections		
March year	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Price measures											
CPI	1.6	0.9	1.5	0.3	0.4	2.2	1.1	1.5	1.7	1.9	2.0
Labour costs	2.1	1.8	1.7	1.8	1.8	1.5	1.9	2.0	1.9	2.2	2.6
Export prices (in New Zealand dollars)	-2.6	-4.8	11.5	-9.2	-0.3	3.9	3.3	1.2	2.7	1.4	2.0
Import prices (in New Zealand dollars)	-1.7	-3.9	-3.0	-3.4	1.2	0.6	1.9	4.5	-1.3	0.5	1.0
Monetary conditions											
OCR (year average)	2.5	2.5	2.5	3.4	2.9	2.0	1.8	1.8	1.3	0.9	1.1
TWI (year average)	72.2	74.0	77.6	79.3	72.6	76.5	75.6	73.4	73.0	72.8	72.5
Output											
GDP (production, annual average % change)	2.3	2.2	2.6	3.7	3.6	3.7	3.1	2.7	2.4	3.1	2.6
Potential output (annual average % change)	1.7	2.1	2.5	2.9	3.1	3.1	3.1	2.9	2.7	2.6	2.5
Output gap (% of potential GDP, year average)	-1.6	-1.5	-1.4	-0.7	-0.2	0.3	0.4	0.3	-0.1	0.4	0.5

Figure 3: Summary of economic projections from the RBNZ's Monetary Policy Statement, 7 August 2019.

With this preparation, and given the new OCR of just 1.00 percent, it appears to be only a matter of time until New Zealand will see negative interest rates introduced. It would now only take a moderate weakening of the growth outlook to get into this territory since there is not much of a buffer left at an OCR that low.

However, once the OCR reaches negative territory, because there are limits to negative rates, the next step is logical and programmed: the RBNZ would then be prepared to go into quantitative easing, starting with government bonds but already eyeing other asset classes. It is in this context that we have to see the RBNZ's Review of Mortgage Bond Collateral Standards, which it started in November 2018.[13] By creating a new market for mortgage-backed securities, the Bank is developing assets that it can later buy once it has moved to quantitative easing.

The end game: The Reserve Bank as a secondary Treasury or a new wealth fund?

The RBNZ understands that with the move towards unconventional monetary policy, the nature of its operations will change. From a central bank conducting monetary policy with the goals of price stability and sustainable maximum employment, it will be become a monetary institution conducting fiscal policy. These are not our words but the words of Governor Orr. It is reassuring that he realises the significance of this transformation.

Under quantitative easing, the RBNZ could become an alternative to Inland Revenue and the Treasury as it would provide (indirect) funding to the government by purchasing government bonds. If it went beyond that and started purchasing corporate assets, it could also morph into something resembling a sovereign wealth fund. If it chose to fund projects of a certain nature (say bonds with an infrastructure background or related to specific policy areas), it would again be more akin to Treasury.

In either of these scenarios, the RBNZ's original focus on inflation and employment could be distracted. The Bank might feel required to use its fiscal actions to align itself with the Government's conventional fiscal policy and, almost as badly, market observers may expect that they would. The wording in the Remit for the Monetary Policy Committee at least suggests that the Bank should be *generally* supportive of the Government's economic policy agenda – and not just of those elements that would typically fall within the realm of monetary policy.

Under normal economic circumstances, the commitment to the Government's other objectives would be mere prose without consequence. Once the nature of the RBNZ changes, however, this prose could be read as part of the Monetary Policy Committee's mandate. It could mean that the RBNZ should take the Government's policy aims into account when conducting quantitative easing.

For example, it could mean that the RBNZ might preferentially purchase infrastructure bonds or bonds to finance renewable energy projects. If that were to happen, the Bank's independence could be called into question. In this context, it is at least unhelpful to have the Governor of the RBNZ expressing his policy preferences for increased infrastructure spending, as he did on TVNZ's Q+A programme on 12 August 2019.

There is only one certain way to prevent such a perception and such a dilemma. It would require the Governor and the Minister of Finance to rephrase and clarify the Remit of the Monetary Policy Committee to reflect unconventional monetary policy.

The easiest option would be to remove the Government's Economic Objective from the Remit. It sits awkwardly in this document anyway since conventional monetary policy would usually have little to do with achieving the Government's non-monetary objectives. This is not to say that the Government's Economic Objective was in any way mistaken but that responsibility for achieving most of the goals enumerated lies with other government agencies.

Regardless of whether the Minister and the Bank are willing to reword the Remit to provide that clarity, it would be very helpful if the Governor were to make very clear that, in the pursuit of any fiscal or quasi-fiscal policies, the RBNZ shall only be guided by its two monetary policy objectives: maintaining a stable general level of prices over the medium term and supporting maximum sustainable employment.

The shock that markets experienced as a result of the unanticipated 50 basis point cut on 7 August should serve as a reminder as to how important it is that any central bank communicates its objectives and planned actions well in advance. Such guidance to markets is even more important should we leave conventional monetary policy behind. The RBNZ itself has repeatedly, and correctly, pointed this out.

We therefore believe that there need to be clear rules to govern the RBNZ's conduct in unconventional circumstances and there must not be the hint that any of the RBNZ's asset purchases are guided by anything other than its monetary objectives.

ENDNOTES

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5 'Reserve Bank prepares for negative interest rates', Politik.co.nz, 8 August 2019, http://politik.co.nz/en/content/economy/1623/Reserve-Bank-prepares-for-negative-interest-rates-Reserve-Bank-Adrian-Orr-Monetary-Policy-Committee-negative-interest-rates.htm.

6 "While there is no need to introduce unconventional monetary policies in New Zealand at this time, it is prudent to learn from other countries' experiences and examine how such polices might work in New Zealand if the need arises," (see page 3 of S. Drought, R. Perry and A. Richardson, *Aspects of implementing unconventional monetary policy in NZ*, Reserve Bank Bulletin Vol. 81. No. 4. May 2018, https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2018/rbb2018-81-04.

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