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Alternative Monetary Policy Statement

September 2011

This *Statement* is produced to help hold the Reserve Bank accountable for avoiding “unnecessary instability in output, interest rates and the exchange rate”, as it is required to do under clause 4 (b) of the Policy Targets Agreement (see http://www.rbnz.govt.nz/monpol/pta/3517828.html)

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1 Policy assessment

The latest international financial turmoil combined with continued spare capacity in the economy reinforces the assessment that the neutral level of the OCR is well below the historical average level. It is therefore appropriate to leave the OCR unchanged at 2.5% for the time being.

If the financial crisis heals and/or unsustainably strong economic growth excluding the rebuilding in Canterbury eventuates some increase in the OCR will be justified. But there do not seem to be any good reasons to expect an early resolution of the international financial crisis. Equally, there does not appear to be a sound basis for expecting unsustainably strong underlying economic growth. By contrast, there is the risk that the latest turmoil could be a dress rehearsal for a more significant shock. If the financial crisis deteriorates further it is possible that an OCR below 2.5% will be justified.

The unemployment rate continues to be the most useful leading indicator of domestic or underlying inflation. With the unemployment rate still being somewhat above the historical average level there remains a case for the OCR being marginally below the neutral level. A modest period of above average underlying economic growth is justified before returning the OCR to the neutral level, which is currently assessed to be in the 3-3.5% range. Using economic forecasts as a basis for assessing the year-ahead outlooks for economic growth and the unemployment rate remains a dubious practice. But there are good reasons for believing that underlying economic growth will not exhibit strength of the sort that would justify the OCR being increased to the neutral level for some time, including the unfolding and potentially damaging deteriorating in the international trade cycle.

When the reconstruction work in Canterbury eventually gets underway in earnest it will provide a significant but transitory boost to economic growth and to inflation. The focus of monetary policy should be on underlying economic growth excluding the boost from the reconstruction work. To hike the OCR in response to the rebuilding post a major and tragic natural disaster makes no more sense than does cutting the OCR once the rebuilding work eventually tails off. All doing so would achieve is create unnecessary volatility in economic activity and especially housing market related activity outside of Canterbury.

Despite 2011 being an election year the government is running what appears to be a sound fiscal with a focus on reducing the fiscal deficit. A case does not existing for increasing the OCR to provide a warning signal to the government.

2 Assessing the neutral level of the OCR

Prior to the crisis ….. charts, take from one of earlier reports …

Reason for new, lower neutral

Chartss –

Historical average of OCR before the crisis

Increase in gaps between borrowing rates and OCR => how much lower neutral is

Also spare capacity in the economy, so it can be a touch below neutral until spare capacity eaten up

Litmus test – if it is too low then housing is first point of call … housing well below average

ANZ National 4.5-5% neutral etc …

2 Restating the case for a more stable OCR

The primary objective of monetary policy is to keep inflation low on average over the medium term, as specified in clause 2 (b) of the Policy Targets Agreement most recently signed between Governor Bollard and the Minister of Finance on 18 December 2008:

"For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term."

Source: http://www.rbnz.govt.nz/monpol/pta/3517828.html

Inflation was made the primary objective of monetary policy more than because keeping it low is desirable in its own right and because monetary policy is the best tool to target inflation. Of most importance, it put the RBNZ in the path of any government planning on making excessive use of taxpayers' money to buy votes. This is best considered in the context of overly-expansionary and self-serving fiscal policy being the primary cause of NZ's high and damaging inflation in the 1970s and 1980s.

With keeping inflation low on average over the medium term being the primary objective of monetary policy it makes sense to me that the RBNZ devotes most of its resources to assessing the level of the OCR that is consistent with this medium term objective (i.e. the neutral level). If there is a major structural change, like the international financial crisis, the neutral level of the OCR will change and the RBNZ should adjust the OCR based on an updated assessment of the neutral level. Equally, if the government of the day plans on operating excessively expansionary and self-serving fiscal policy the RBNZ should adjust the OCR to encourage more responsible fiscal policy.

But how much should the RBNZ adjust the OCR relative to the assessed neutral level? This is effectively asking how can the RBNZ best satisfy clause 4 (b) of the Policy Targets Agreement – the stability clause – in addition to keeping inflation low on average over the medium term. The historical evidence makes a strong case for believing that the RBNZ's best chance of satisfying clause 4 (b) is if it keeps the OCR in reasonably close proximity to the assessed neutral level. This compares to the RBNZ inclination to march the OCR up the hill, just to march it back down again.

The RBNZ, like central banks in general, puts most of its effort into assessing the outlooks for the economic growth, inflation, the international situation etc. It then adjusts the OCR "proactively" based on this assessment in the belief this will result in a more stable or less unstable economic environment than would exist otherwise. Since its birth in early 1999, but prior to the financial crisis beginning, the OCR ranged from 4.5% to 8.25%. Over the last two decades, excluding the period since the financial crisis started, the 90-day bank bill yield, the benchmark short-term wholesale interest rate that is largely controlled by the RBNZ's monetary policy decisions, ranged from 4.3% to 10.2%. The RBNZ's "proactive" approach to adjusting the OCR has resulted in extremely unstable interest rates, which has made life much tougher than necessary for borrowers and savers. Consequently, rather than avoiding unnecessary volatility in "output, interest rates and the exchange rate" the RBNZ has been a primary cause of volatility.

To successfully adjust the OCR "proactively" (i.e. so as to avoid unnecessary volatility in the economy) the RBNZ needs to be able to accurately forecast economic growth a year in advance on a consistent basis because it takes around a year for changes in the OCR to filter through to economic activity. If the RBNZ can on a consistent basis predict upturns and downturns in economic activity a year in advance the potential existing for it to successfully adjust the OCR proactively. However, even if the RBNZ is successful at reducing volatility in economic activity by proactively adjusting the OCR it will contribute to volatility in interest rates.

The problem with the RBNZ's forecasting-based approach to adjusting the OCR is that the RBNZ and the economic forecasters more generally have poor and at times abysmal track records at predicting economic upturns and downturns. Consequently, the RBNZ ends up adjusts the OCR reactively (i.e. after an economic upturn or downturn has been confirmed by the historical economic data). By adjusted the OCR after the horse has bolted the RBNZ does not reduce volatility in economic activity but is instead a major cause of such volatility.

In the three precursor reports to this ***Alternative Monetary Policy Statement*** I documented the RBNZ's poor forecasting track record and showed why this meant the RBNZ was a primary source of volatility in the economy, especially for interest rate sensitive industries (visit sfajf ;fjas;f ;fja;fjas;f ; to access these reports). But the evidence against the RBNZ's forecasting-based approach to adjusting the OCR continues to mount.

In the 2011 June MPS the RBNZ estimated that economic activity or GDP increased 0.4% in the 2011 March quarter. On 14 July 2011 Statistics NZ reported a 0.8% increase in GDP for the March quarter. Partly in response to this stronger than expected quarterly increase in GDP the bank economists barked louder about the need for early and sizeable OCR hikes. In the 2011 September MPS the RBNZ estimated that GDP increased 0.6% in the 2011 June quarter. On 22 September 2011 Statistics NZ reported a 0.1% increase in GDP for the June quarter. This poured some much needed cold water on the barking bank economists, but it won't stop them from barking.

The evidence from the last two quarters is that even after the event the RBNZ can't be relied upon to estimate what happened to GDP. If the RBNZ can't estimate what happened after the event with a reasonable degree of accuracy how can it expect to be able to forecast what will happen to economic growth over the next year?! These events reinforce my belief that the RBNZ should abandon the pretence that it can successful adjust the OCR proactively and that it should instead focus its attention much more than it does on assessing the neutral level of the OCR.