Graeme Wheeler: Central banking in a post-crisis world

Speech by Mr Graeme Wheeler, Governor of the Reserve Bank of New Zealand, to the Admirals' Breakfast Club, Auckland, 26 October 2012.

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(I) New Zealand's vulnerability in international markets

In "Les Miserables", Victor Hugo wrote of the vulnerability of a little black cat.

"We all know the habit of cats of hesitating in an open doorway – hovering uncertainly at the risk of being crushed by the closing of the door."

New Zealand shares this sense of vulnerability. We are a small economy – around four and a half million people in a world of seven billion, producing output roughly three-quarters of that of Queensland. Our vulnerability is increased by our habit of not saving enough for our investment needs, resulting in a large accumulation of foreign debt.

Yet, we face the world with tremendous assets. The World Bank suggests that on a per capita basis, New Zealand is ranked eighth for natural capital (pastoral and crop land, forest resources and subsoil etc) with only oil producing countries ahead of it. We lead the world in renewable natural resource related capital. OECD comparisons of high school student attainment place us seventh among 71 countries. Transparency International considers New Zealand the least corrupt country in the world, and the World Economic Forum ranks New Zealand among the best for the quality of its institutions, and the efficiency of its product markets and its financial markets.

With these assets we should be capable of stronger economic growth. Internationally, and particularly in smaller economies, economic growth is driven by the private sector and its ability to compete on global markets. We need to reverse the slowdown in multifactor productivity growth since 2005 and the decline in value added in our tradables sector. And we need to reverse the shift of resources into the public sector and other non-traded activities.

Our economy is continually buffeted by external shocks. Some are natural events, like the catastrophic series of Christchurch earthquakes that represent the sixth largest global insurance payout ever. Others reflect tectonic shifts in the global economy. These include the rapidly growing importance of East and South Asia in international trade and investment, the rising global demand for commodities, and the changing global saving and investment patterns associated with the expanding middle class in developing economies and demographic aging in the western economies and Japan. The integration of financial markets, reduction in trade barriers, and global diffusion of skill enhancing technologies, and especially information technologies, mean that economic shocks are transmitted more rapidly across the globe and business cycles become more synchronised.

Overlaying these structural shifts are enormous economic adjustments flowing from the global financial crisis. Household balance sheets, especially for the lower and middle income classes, have been severely damaged in the US and large parts of Western Europe. This process of deleveraging debt and rebuilding wealth is likely to take several more years. For example, the Federal Reserve reports that median real net household wealth in the U.S. fell 39 percent from 2007 to 2010 to levels last seen in 1992. In 2011, the median real level of US household income dropped to its lowest level since 1995.

In many countries, the banking and commercial real estate sectors are still contracting, and the indebtedness of the banking sector in the Euro Area remains very high. Tensions remain around large current account imbalances, exchange rate pressures, slow growth, and high unemployment. Across much of the developed world, as in New Zealand, real incomes per capita have yet to recover to 2007 levels.

The world is very different from the heady days of 2003 – 2007 when the global economy grew at its fastest rate in four decades and international fora debated whether the growth dynamics of the emerging economies were becoming decoupled from the industrialised world. No-one believed that the banking system could fail in a G7 economy – let alone a group of G7 economies. Nor did they contemplate how rapidly fiscal positions could be overwhelmed by lower tax revenues and pressures on governments to become investors and guarantors of last resort – in areas well beyond their traditional investor habitat and risk tolerance.

We are in new territory for central banking. For the past three to four years policy rates in the U.S., the Euro Area and in many other countries have been at historic lows, some short-term government securities markets are returning negative yields, and the Bank of International Settlements reports that the volume of central bank assets in the advanced countries – itself largely a result of massive liquidity injections – expanded to 25% of GDP, double the ratio of 2007. Forward curves and forward guidance by the major central banks suggest that interest rates will remain at historic lows for at least another two to three years.

These policy settings are unprecedented. The challenge will be to transition to more normal monetary conditions before high rates of inflation and widespread escalation in asset prices are generated. We have already seen bull markets in commodities, gold, and fixed income markets, and a rapid contraction in credit spreads in emerging markets and high yield debt as investors search for higher returns.

With this international backdrop, and with internal debate over New Zealand's economic prospects, there has been public commentary on the appropriate goals for the Reserve Bank. This includes suggestions that the Reserve Bank should tolerate higher inflation, give greater emphasis to economic growth and unemployment, target nominal income, or the exchange rate, or interest rates, and apply loan to value limits to contain the Auckland housing market. I will explore some of these issues.

(II) The importance of price stability and an efficient and stable financial system

Price stability and financial stability remain the Reserve Bank's central objectives for monetary policy and prudential policy. These provide the best framework for achieving stronger growth in output and employment in the longer term. Price stability enables households, businesses, and governments to plan with greater certainty; it facilitates long term contracting; lowers the inflation risk premia embedded in interest rates; and enables producers, consumers, and investors to respond to opportunities created by changing relative prices rather than diverting resources to hedge against inflation.

The recent Policy Targets Agreement (PTA) reinforces the importance of price stability and introduces the goal of keeping future average CPI inflation near the 2 percent target mid-point of the 1 percent to 3 percent range. Over time, attaining this outcome should help to anchor inflation expectations around the mid-point.

Deep, efficient and well-regulated financial markets facilitate economic growth by helping to channel funds to their most productive uses and to allocate risk where it can best be borne. Where economic policies and regulatory structures are sound and conducive to competition, financial markets can enhance productivity and create opportunities for saving, accessing credit, and buffering people against difficult times.

Over the past four years the world has again witnessed the destructive power of dysfunctional financial markets. Financial sector instability can arise from many sources, including unrealistic expectations as to the sustainability of future yields on financial assets, excessive risk taking by investors, poorly designed macro-economic and regulatory policies, and through regional or global contagion from failures in offshore financial systems.

The importance of a stable and well-functioning financial system is also recognised in the PTA with its emphasis on the need to monitor asset prices and to have regard to the efficiency and soundness of the financial system. Prior to the global financial crisis the debate in central banking circles had been how hard should monetary policy lean against asset bubbles in order to diminish the spill-over of "wealth effects" into excessive demand growth and inflation. While these spill-overs will continue to be an important policy consideration during buoyant asset markets, central bankers and fiscal authorities are now much more conscious of the deflationary impact of collapsing asset prices and the deleveraging it triggers, particularly if the banking system is put at risk and governments are called on for bailouts.

For these reasons the Reserve Bank has placed a high priority on strengthening New Zealand's prudential regime, including introducing macro-prudential instruments and having an open bank resolution capability in place. Macro-prudential instruments are being developed in many countries and in our case we are focusing on instruments such as the core funding ratio, the counter-cyclical capital buffer, adjustments to sectoral risk weights, and housing loan-to-value ratio limits. These instruments are expected to reinforce the overall tougher approach to prudential regulation and supervision under the new Basel III regime. We need to ensure that we have well governed and well capitalised financial institutions, with strong funding and liquidity buffers, and sound risk management practices.

Although macro-prudential instruments are likely to be used infrequently, they will provide additional buffers to the financial system that vary with the macro-credit cycle. Their purpose is to help maintain a sound and efficient financial system, but in most instances the instruments will also reinforce the stance of monetary policy.

A Memorandum of Understanding between the Minister of Finance and the Governor of the Reserve Bank is currently being discussed with the Treasury. It will confirm the guidelines under which the Bank should operate macro-prudential instruments in "promoting the maintenance of a sound and efficient financial system". It will also outline the consultation processes with the Minister and the Treasury if macro-prudential intervention is under consideration, and prior to any decision to deploy macro-prudential policy instruments.

Maintaining financial stability requires mechanisms to manage financial distress. Open Bank Resolution (OBR) will enable a distressed bank to continue operating, while placing the cost of the bank's failure on the bank's shareholders and creditors, rather than taxpayers. Although bank failures in New Zealand are very rare, OBR will provide the Government with a real alternative to bailout. It will reduce the risks of moral hazard, and strengthen the incentives for banks to operate prudently and to pursue private sector solutions in the event of crisis. The Reserve Bank is working with banks to ensure that OBR is a live option by 30 June 2013.

We are also reviewing other financial institutions as part of our prudential oversight responsibilities. This includes working with over 100 insurers in New Zealand to ensure that they meet the Reserve Bank's new licensing standards by 7 September 2013. We are also working to establish a licensing framework for around 60 non-bank deposit takers that we currently regulate.

(III) Quantitative easing, targeting growth and the exchange rate

Pursuing price stability and using our prudential powers to promote financial system stability and efficiency, are the greatest contributions that the Reserve Bank can make to fostering New Zealand's long term economic growth. We do not see any reason to adopt quantitative easing in New Zealand. Quantitative easing is being adopted by central banks that have little or no scope to lower interest rates in economies experiencing major deleveraging, and where deep concerns exist about generating and sustaining economic growth. It is a sign of desperate times for central banks, who in some instances are shouldering the burden of domestic policy paralysis over fiscal policy. Since the onset of the global financial crisis, the Federal Reserve has expanded its balance sheet by 13 percent of GDP, the European Central Bank by 16 percent of GDP, the Bank of Japan by 10 percent of GDP, and the Bank of England by around 20 percent of GDP. In all four cases the official cash rate is 0.75 percent or less. In all four cases there is little evidence of any appreciable impact on economic growth.

New Zealand is in a very different situation. Our economy is growing at an annual rate of around 2 percent and the Reserve Bank has scope to lower interest rates if needed. While annual CPI inflation has fallen to 0.8 percent, we expect inflation to head back towards the mid-point of the target range. We will continue to monitor inflation indicators, such as pricing intention and inflation expectation data, closely over the coming months as stronger residential investment gets into full swing.

We do not see scope for directing monetary policy to achieve target rates of economic growth. This lies beyond the capability of monetary policy. Trend rates of economic growth depend largely on the quantity and quality of human capital and the amount and productivity of the capital that labour has to work with. But, we do examine the state of the economy very closely when setting monetary policy. We study a range of economic indicators such as building and manufacturing activity, measures of capacity, conditions in the labour market, trends in competitiveness, and forward indicators of orders and investment intentions. Doing so enables us to get a better feel for the pressures on resources and to assess whether there is scope to support stronger growth in demand while achieving our inflation objectives.

There is considerable public debate on the exchange rate. Several external commentators, such as the International Monetary Fund (IMF), suggest that the exchange rate is over-valued in terms of economic fundamentals. Some of the strength in our exchange rate is a reflection of the weakness of the US dollar. On a bilateral basis the New Zealand dollar is especially strong against the US dollar, Euro and Sterling. Against the Australian dollar, it has tracked slightly below average.

Ultimately, it is the relative rates of return between New Zealand and the rest of the world that explains the strength of the New Zealand dollar. These returns reflect developments in the economy and international demand for our products and services. Over the longer haul the dollar is very strongly correlated with measures of the terms of trade or commodity prices, and much of the strength of the New Zealand dollar is due to our terms of trade being close to a 40 year high. Exchange rate movements can also reflect differences in growth rates between economies, differences in interest rates, perceptions of safe havens, and fluctuations in investor risk appetite.

New Zealand is not alone in experiencing upward pressure on its exchange rate. Several commodity producing countries, and countries with stronger growth rates and positive interest rate differentials compared to the U.S. and Euro Area, have experienced substantial currency appreciation since the global financial crisis.

The appreciation in our exchange rate has affected the tradables sector of the economy. Manufactured export volumes, although growing at around 3 percent a year since the global financial crisis, are lower than they would otherwise be; investment in industries such as tourism has declined; and the profitability and output of import competing industries is reduced. On the other hand, resources shifted to the more sheltered and less competitive non-tradables sector where producers find it easier to raise prices. The high exchange rate does however, generate some important benefits to the economy. Consumers and producers benefit from lower import prices, and interest rates are lower than would otherwise be the case.

The Reserve Bank wishes to see a lower exchange rate provided it can be achieved without damaging price stability and financial stability. In the wake of the global financial crisis, institutions such as the IMF, are reviewing the scope for managing capital flows. Capital controls may be appropriate in some circumstances, perhaps to mitigate problems arising from temporary surges in capital inflows in economies with weak financial sectors. For a debtor country like New Zealand, an open capital account is essential. Introducing capital controls, instead of making the necessary adjustments, would damage the credibility and stability of New Zealand's financial sector, and increase the real cost of capital for New Zealand.

Reducing interest rates can at times reduce pressure on the exchange rate but analysis of past OCR cuts in New Zealand shows on average minimal or no intra-day impact on the exchange rate, and even less impact on a weekly basis. Analysis of "unexpected" OCR changes with Trade Weighted Index changes following a rate decision still does not show a strong relationship to subsequent movements in the exchange rate. This reinforces the idea that the exchange rate primarily reflects returns in the broader economy rather than simply returns in the money market.

We set the OCR such that the inflation outlook remains consistent with the PTA and the financial markets understand this. If we reduced the OCR without sound reasons the exchange rate might drop initially but rise later when the inflationary implications of the rate cut became clear, especially if the belief was formed in the meantime that the central bank's commitment to price stability was wavering.

Foreign currency intervention is unlikely to have a sustained impact on the New Zealand dollar, but can have an impact in the short term if the Reserve Bank makes the right calls about the exchange rate departing from fundamentals. The Reserve Bank has four criteria to assess whether intervention should be undertaken. These are: whether the exchange rate is exceptional relative to history; is the exchange rate justified; would intervention be consistent with the PTA; and whether the market conditions exist to successfully shift the value of the currency. Even if the first three criteria are satisfied at a point in time, it makes little sense to risk incurring losses to taxpayers by intervening when currency flows supporting the New Zealand dollar are particularly strong. But we will remain vigilant on these criteria and will be prepared to intervene if all conditions are met.

So there are clear limits to what monetary policy and exchange rate intervention can do to lower the New Zealand dollar. In order to achieve a sustained reduction in the New Zealand dollar it would be necessary to alter the overall level and pattern of saving and investment in the economy. In particular, it will be necessary to tackle our addiction of depending on foreign savings to finance our consumption and investment. This dependency means that we have persistently needed interest rates above those in most developed economies to maintain inflation at target levels similar to those being followed elsewhere. Policies that increase domestic savings, including reducing the government's fiscal deficit, and to reduce the flow of resources into the public sector and other non-tradables sectors, would help to achieve a sustainable reduction in the exchange rate.

(IV) Concluding comments

Throughout the world, monetary policy is being conducted in a highly challenging environment. Years of close to zero interest rates and massive liquidity injections in the U.S., Japan and Euro Area are creating negative spill-overs for smaller economies such as New Zealand. Difficult adjustments lie ahead as the major central banks try to re-establish more normal monetary conditions and prevent inflation from moving beyond target levels. And, in New Zealand, we have never had to conduct monetary policy when a major part of the economy faces a concentrated construction programme in the order of 12 percent of GDP – and insurance payouts in excess of this.

Various groups in our economy are under pressure from the high exchange rate, rising house prices, and those living off interest income worry about low yields. Monetary policy, by itself, cannot deliver quick fixes to achieve and sustain more rapid economic growth, lower unemployment, or maintain a lower exchange rate. Other policies are central for achieving these outcomes, but when they are applied, monetary policy can be supportive of them.

In conducting monetary and prudential policy, the Reserve Bank will be consistent, open, and flexible in reflecting on new information and data. In doing so, our focus will remain on meeting the objectives in the PTA and maintaining New Zealand's reputation for credible monetary policy outcomes and financial stability. This is the best contribution we can make to help bolster New Zealand's rate of economic growth and serve New Zealanders.

Graeme Wheeler