Graeme Wheeler: Monetary policy challenges in turbulent times

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I will discuss some of the main challenges confronting central banks in conducting monetary policy, particularly in small open advanced economies. The scope and influence of monetary policy in these economies is heavily constrained by economic and financial developments outside their borders. As a result, expectations of what monetary policy can achieve often run ahead of reality. I will then discuss some of the alternate views around an appropriate strategy for managing monetary policy in New Zealand under current circumstances. I will conclude by discussing the Reserve Bank's current policy strategy. In doing so, I will draw heavily on and emphasise the messaging contained in the recently released August *Monetary Policy Statement*.

I) Challenges faced by central banks in implementing monetary policy

Nearly ten years on from the start of the Global Financial Crisis (GFC), growth remains disappointingly weak in many regions. The IMF's latest *World Economic Outlook* is appropriately titled *"Too Slow for Too Long"*. It includes further downgrades in 2016–2017 growth projections for all the major economies, and for many emerging and developing economies. Tangible downside risks were identified, and the projections were shaded down further in July revisions. A similar picture emerges in the OECD's latest *Economic Outlook*, which highlights the "self-fulfilling low growth trap" that has enveloped the global economy.

Central banks face a difficult global economic and financial environment:

- global economic growth remains significantly below its long-term average despite unprecedented monetary accommodation.[1] The rate of potential output growth across the advanced economies has slowed due to lower growth in total factor productivity and weak growth in the capital stock.[2] Output growth in the emerging markets has also slowed;
- The volume of global merchandise trade (which is a strong catalyst for global economic growth) has drifted lower since the start of 2015. In an environment of weak economic growth and reduced trade volumes, trade restrictions in G20 countries have

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[1] Global GDP growth has averaged 3.8 percent per annum since 1961. The decline in output from the pre-GFC trend path of GDP has been 15 percent or more in several countries. Global growth in 2015 was 3 percent, the weakest since 2009, and below trend growth of 3.8 percent.

[2] Potential output growth per capita in the OECD area has declined from around 2 percent in the late-1990s to around 1 percent at present. Analysis cited by the OECD indicates that about half of this slowdown is due to weak capital stock growth – reflecting both lower investment since before the GFC, and higher rates of depreciation arising from the growing share of ICT and intangibles in total investment. The other half of the slowdown is attributed to lower growth in total factor productivity (TFP), reflecting weaknesses in the spread of innovation through the economy, in business dynamism, and in product market reform. Potential output has also been held back by weak labour market performance, including deteriorating skills of the long-term unemployed, and by the impact of weak global trade in holding down the benefits to growth arising from competitive pressures, technological spill overs, and innovation.

been rising steadily[3] and many governments are concerned about the strength of their exchange rates;

- headline and core inflation and short-term inflation expectations in the advanced economies are very low, and the level of neutral interest rates has fallen;
- interest rates are at historic lows and countries with negative policy rates now account for 25 percent of global output.[4] The volume of quantitative easing by central banks is expected to reach record levels in 2016. Around US$13.4 trillion of bonds carry a negative yield; and
- high asset valuations are presenting risks to financial stability in many economies and the level of household debt remains high (and has been rising rapidly in several large emerging market countries).

The conduct of monetary policy has become more complicated as global financial integration has continued to increase, and as the financial policy spillovers arising from the extraordinary monetary policy measures of the major central banks have increasingly been felt in the smaller and peripheral markets.[5, 6]

Many of these issues are likely to be long lasting. They have complex structural elements to them and are unlikely to fully self-correct as global growth recovers. For example:

- low inflation in some countries is linked to demographic change, especially in countries with a declining workforce and rapidly ageing population. Low inflation is also due to technological change around information flows and energy production, and to the global over-supply of commodities and manufactured goods; and
- the decline in neutral real interest rates may be linked to the slowdown in productivity growth, and the growth in global savings linked to post-GFC deleveraging and aging populations.

In responding to this economic setting, monetary policies are being stretched well beyond the normal parameters and stresses envisaged when policy frameworks were designed and inflation goals were first specified.

II) Questions that central banks are grappling with

In a world of unconventional monetary policy and unprecedented monetary accommodation, several questions are on central bankers' minds; questions such as:

- what are the risks that global growth will be revised lower? What is the outlook for commodity prices, and especially oil prices? How can the advanced economies

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3 The last five years of merchandise trade growth has been the weakest period since the 1980s. Between mid-October 2015 and mid-May 2016 G20 economies introduced new trade measures at the fastest pace seen since 2008. (WTO Director General's Mid-Term Report on Trade Developments issues on 25 July 2016).

4 Countries with policy rates at or below 0.5 percent now account for around 65 percent of global GDP. Around USD13.4 trillion of bonds carry a negative yield.

5 Global foreign exchange market turnover reached an estimated $US5.3 trillion a day in 2013, up from $US3.8 trillion in 2007 and $US1.5 trillion in 1998. Global trading in OTC interest rate derivatives – mainly swaps and forward rate agreements – increased almost ten-fold between 1998 and 2013 (from $US265 billion in 1998 to $US2.3 trillion in 2013). The notional amounts outstanding in OTC derivatives markets (mainly interest rate contracts) reached almost $US700 trillion in 2013, compared with $US500 trillion in 2007 and under $US100 trillion in 1998.

6 Chen, J, Mancini – Griffoli, T, and Sahay, R (2014) "Spillovers from United States Monetary Policy on Emerging Markets: Different this Time?", IMF Working paper WP/14/240.

achieve the growth rate needed to generate the "escape velocity" to ensure a durable recovery and moderate inflationary pressure?;

- how long are the major central banks likely to run a divergent monetary policy stance (although they have become more similar as the Federal Reserve has pushed back expectations of interest rate rises)? When might the Federal Reserve next raise the Fed Funds rate?;
- has monetary policy reached the limits of its effectiveness in central banks with negative policy rates and large programmes of quantitative easing? How much scope is there for additional monetary accommodation and will this be deployed – especially by large central banks, such as the European Central Bank and Bank of Japan?;
- how serious are the distortions created by negative interest rates, and by quantitative easing and the associated rapid expansion of central bank balance sheets? How can these balance sheets be deleveraged over time and excess bank reserves absorbed, and what does this imply for monetary policy, asset prices and global long term interest rates?;
- what are the risks that inflation expectations will fall further? How can inflation expectations best be raised when policy rates are already low, household indebtedness is high and households and firms are reluctant to borrow more?;
- how reliable are the central bank's estimates of the output gap? How flat has the Phillips Curve become and how much has the neutral interest rate fallen?; and
- how should fiscal policy support monetary policy?

Monetary policy decisions are influenced by assessments of such questions based on research, modelling and scenario analysis. The complexity of the discussions that underlie policy decisions within a central bank belies the apparent simplicity of what is often a single interest rate instrument and a single inflation target.

III) Policy Choices in New Zealand

New Zealand's economy is in its eighth year of expansion. In many respects the economy is performing well: economic growth is above trend; employment growth has been strong; labour force participation is high; and the unemployment rate continues to decline. Furthermore, real wage growth has been quite strong; until recently, the household savings rate has been rising; and increasing economic growth has not been accompanied by the sharp deterioration in the current account that has accompanied previous recoveries. Not least, the cost of living, as measured by the consumers price index, has been rising slowly.

As with every economy, there are also some negative aspects: domestic economic growth has been weaker on a per capita basis; slow global growth and rising protectionism creates risks for our export sector; the global dairy market has serious oversupply problems that depress our dairy returns (although the last two dairy auctions have been encouraging); excessive house price inflation is creating financial stability risks; our exchange rate is too high and affecting the competitiveness of our export and import substitution industries; and headline inflation (but not underlying inflation) lies below the target band in the *Policy Targets Agreement*. In addition, the strongest migration cycle in several decades is creating stresses as well as positives for the economy.[7]

Monetary policy decisions attract considerable comment in most advanced economies, and New Zealand is no exception. That's because monetary policy can have important effects on

[7] High net immigration raises potential output growth, increases aggregate demand, moderates wage pressure and increases house price inflation.

peoples' lives. It can affect the level of activity in the economy in the short-term, the cost of living for individuals and their expectations about wage and price outcomes, asset valuations, the cost of borrowing and the returns to savers and investors, and the incentives for risk taking.

But several factors constrain the influence of central banks, particularly in small open economies. Long term interest rates are set by global saving and investment flows, country risk premia and expectations for economic growth and inflation. Central banks only have limited control over tradables inflation. For example, they have no influence on the global oversupply of commodities, manufactured goods and capital goods, or on overseas inflation rates. This did not matter so much when the annual increase in New Zealand's import costs in the run up to the GFC was averaging 2 percent, but does when they have averaged minus 1.9 percent in recent years.[8]

Central banks generally have limited control over the exchange rate. For example, the Reserve Bank has lowered the OCR six times since June 2015 and the TWI remains some 2½ percent higher than it was at the commencement of cutting. Central banks cannot persistently achieve a lower nominal exchange rate unless monetary policy is fully dedicated to that goal (and even then cannot permanently achieve a lower real exchange rate). They might influence financial risk taking through short term interest rates, but other factors, such as regulation and taxation, will determine whether this flows through into investments that enhance productivity and real income growth. In addition, the scope that central banks have to influence short-run activity and wage and price setting behaviour diminishes as interest rates approach zero, and the limits for quantitative easing are reached.

Reflecting these constraints, central banks must make finely-balanced judgements when setting monetary policy. We attempt to base those judgements on evidence, research and scenario analysis and continue to review our policy record and international experience to see what we can learn from them. We also encounter a range of views about what monetary policy can achieve and how it should be operated. I will touch on three policy views that have recently been expressed in the New Zealand context.

1. *The view that flexible inflation targeting is not an appropriate framework for conducting monetary policy*

The Bank's position is that flexible inflation targeting remains the most appropriate monetary policy framework for conducting monetary policy in New Zealand.[9] Provided that sufficient flexibility is allowed to accommodate the frequent and often severe impact of external shocks, the most important contribution monetary policy can make to promoting efficiency and the long-run growth of incomes, output and employment is the pursuit of price stability.

This also remains the view of the 30 or so central banks that describe themselves as inflation targeters, and includes most central banks in the advanced economies and several emerging market economies. I am not aware of any central bank that has moved away from an inflation targeting framework since the GFC. For example, no country has adopted price level targeting or targeted nominal income given the practical difficulties and theoretical challenges to those frameworks. However, several central banks, like the RBNZ, have expressed concerns that the unprecedented monetary accommodation in the aftermath of the GFC has led to excessively inflated asset prices. Many countries have introduced macro-prudential policies to help alleviate the risks this poses to domestic financial stability.

8 The average annual percentage change (in NZ dollar terms) in goods and services import prices was 2 percent in the period 2005–2007 and –1.9 percent in the period 2012 – 2016 Q1.

9 Several RBNZ speeches discuss the merits of flexible inflation targeting. For example, McDermott J (2012) "The Future of Inflation Targeting" (2015) "The Dragon Slain? Near-Zero Inflation in New Zealand", Wheeler G (2014) "Reflections on 25 Years of Inflation Targeting" (2015) "Some Thoughts on the Inflation Outlook and Monetary Policy".

There have been assertions that inflation targeting is broken because inflation is low. These assertions do not stack up. Inflation has primarily been low because of unforeseen and unforeseeable global events. Monetary policy in New Zealand remains effective and able to influence domestic demand, and thus, non-tradable inflation.

While there is some academic debate about the merits of different inflation targets, few, if any, central banks have modified their inflation targets in the last few years. Although there is nothing sacrosanct about what particular inflation band or target should be adopted as a measure of price stability, central banks have been reluctant to change targets. This is usually because the prospect of "making it easier when times become tougher" reduces the incentives on central banks to achieve earlier agreed goals and, in doing so, could damage the central bank's credibility (particularly if a perception develops that the central bank will continually seek to respecify goals).

New Zealand's inflation target specification is not out of line with that set by the major central banks. For example, the Federal Reserve, Bank of Japan, Bank of England and the Bank of Canada have adopted inflation goals framed around 2 percent annual inflation (the European Central Bank expresses the goal as "achieving annual inflation rates of below, but close to, 2 percent over the medium term".)

2. The view that the Reserve Bank should not lower interest rates

Proponents of this view argue that the economy is growing strongly and interest rate reductions are unwarranted and undesirable. They suggest that borrowing costs are not constraining business investment, and worry that lower rates will accentuate already excessive house price inflation and sow the seeds for a major housing market correction that will slow growth and likely lead to a recession. They also argue that monetary policy is in danger of focussing too much on borrowers and ignoring the effect that lowering interest rates could have on those reliant on interest incomes. This view acknowledges that inflation could remain at low levels for many years and that we should accept that outcome.

There are two inter-related risks with this approach that are linked to the exchange rate and inflation expectations, and which may lead to even lower inflation. According to the last BIS triannual survey, the New Zealand dollar is the 10th most traded currency in the world with the 2013 data showing average daily turnover of USD105 billion, roughly equivalent to 65 percent of New Zealand's GDP.[10] If financial markets believe that the Bank has abandoned its inflation objectives and is seeking to maintain policy rates at a level consistent with below-target inflation, they will conclude that the easing process is over and proceed to bid the exchange rate up, perhaps substantially so.

The TWI exchange rate is already at a high level based on the Bank's models. A sizeable appreciation would further squeeze incomes in the tradables sector, and drive tradables inflation lower for longer, thereby lowering overall headline inflation. A significantly higher exchange rate that is not matched by a rise in commodity prices would likely slow economic growth.

But it also carries another important risk. Low headline inflation increases the risk that inflation expectations might fall and become embedded in wage and price setting outcomes that become self-perpetuating and drive headline inflation lower. The outcome might be an economy with less house price inflation, but with a higher exchange rate, slower growth, and lower inflation.

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[10] BIS "Triennial Central Bank Survey, Foreign Exchange turnover in April 2013: Preliminary Global Results".

If inflation expectations fall too far, it can be very difficult to raise them back up. In such a situation, further cuts in interest rates would be needed to stimulate economic activity and increase inflationary pressures.

3. The Reserve Bank should rapidly lower interest rates

This view advocates bringing inflation quickly back to the mid-point of the inflation band by rapidly cutting the OCR. Driving interest rates down quickly would lower the exchange rate, contributing to increased traded goods inflation and stronger traded goods sector activity. The ensuing increase in house price inflation is not seen as a consideration for monetary policy, even though there would be an increased risk of a large correction in the housing market and associated deterioration in economic growth.

There would be considerable risks in this strategy. An aggressive monetary policy that is seen as exacerbating imbalances in the economy would not be regarded as sustainable and would not generate the exchange rate relief being sought.

With the economy currently growing at around 2½ – 3 percent and with annual growth projected to increase to around 3½ percent, rapid and ongoing decreases in interest rates would likely result in an unsustainable surge in growth, capacity bottlenecks, and further inflame an already seriously overheating property market. It would use up much of the Bank's capacity to respond to the likely boom/bust situation that would follow and would place the Reserve Bank in a situation similar to many other central banks of having limited room to respond to future economic or financial shocks.

Such consequences suggest that a strategy of rapid policy easing to extremely low rates would be counter to the provisions in the PTA that require the Bank to "seek to avoid unnecessary instability in output, interest rates and the exchange rate" and to "have regard to the soundness of the financial system".

IV) The Reserve Bank's current approach

I will outline the thinking that underpins our August *Monetary Policy Statement*.

The Bank recognises the considerable flexibility that has deliberately been built into the PTA. This includes provisions that:

- deliberately frame the inflation objective in terms of an inflation band with an "on average over the medium term" connotation;
- recognise that commodity price movements, such as oil prices, and government tax and pricing decisions may move measured inflation outside the band;
- require the Bank to monitor asset prices and have regard to financial stability risks; and
- avoid unnecessary instability in output, interest rates and the exchange rate.[11]

The forecasts contained in the August Monetary Policy Statement have the economy's output gap currently at zero and rising to around 1.2 percent of GDP in 2018. We assess core inflation to currently be within the lower half of the target band and headline inflation is forecast to reach the lower end of the target band in December 2016. The output and inflation projections assume 35 basis points of further OCR cuts from the current level of 2.00%.

[11] For an explanation of how the Bank interprets the PTA and the considerations that lay behind the changes introduced at the last review see Wheeler G (2016) "The Global Economy, New Zealand's Economic Outlook and the Policy Targets Agreement".

The key rationale for cutting the OCR by 25 basis points in August was to lower the risk of a further decline in short-term inflation expectations.

In terms of the monetary policy transmission mechanism, we see the primary influence working through the demand and risk taking channels that raise annual non-tradable inflation to just under 3.5 percent over the projection period. We also anticipate that as our interest rate differentials narrow against other advanced economies, the exchange rate will weaken and, along with an increase in commodity prices and gradual rise in world inflation, will help traded goods inflation to move into positive territory.

Our decision to further lower the OCR does increase the potential risk of further fuelling increases in asset prices, including within the housing market. This is one of the difficult trade-offs that we have had to confront. The risks here are partly balanced by our macro-prudential policy moves that will further boost the resilience of the banking system.

It may sound trivial for central banks to note that they will closely monitor the emerging economic data, but that is the reality of the situation in a world where there are major uncertainties and every indicator of growth and inflation is carefully scrutinised. The Bank's output and inflation projections, and the associated interest rate track, are based on a series of assumptions and judgements that are continually tested in the light of new information and analysis. It is this emerging economic data that will determine whether the assumed 35 basis points of further easing is realistic or whether more or less monetary stimulus will be required.

V) Concluding comments

Central banks do not have special powers of market foresight or a franchise on wisdom. But they do have significant research and analytical capacity that can deliver valuable insights, and this is being applied to challenges associated with the current global economic and financial developments. It means that central banks are in a position to modify their perspectives and policies as new analysis and data becomes available.

In the end, judgement is inevitably involved in balancing a range of risks and uncertainties. Some of these lie beyond the influence of the central bank, while others can be addressed or moderated through monetary policy. Policy decisions inevitably involve reflection and pragmatism in managing different trade-offs.

We remain committed to the inflation goals in the Policy Targets Agreement. Our present judgement is that the current interest rate track, involving an expected 35 basis points of further interest rate cuts, balances a number of risks weighing on the economy while generating an increase in CPI inflation back towards the midpoint of the 1 to 3% target range. We do not believe that the outlook and balance of risks warrants a position of no policy change, nor a position of rapid easings. If the emerging information and risks unfold in a manner that warrants a change in our judgements, we will modify our policy settings and